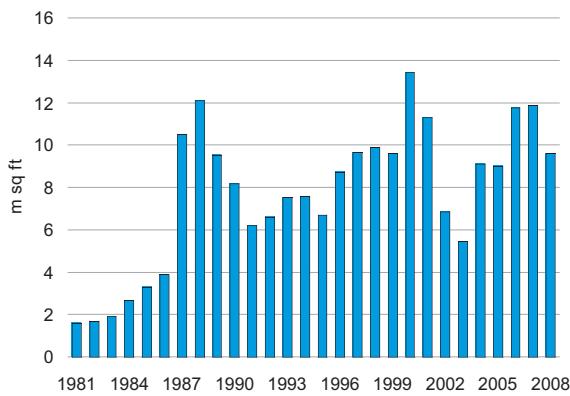


Central London office review & outlook

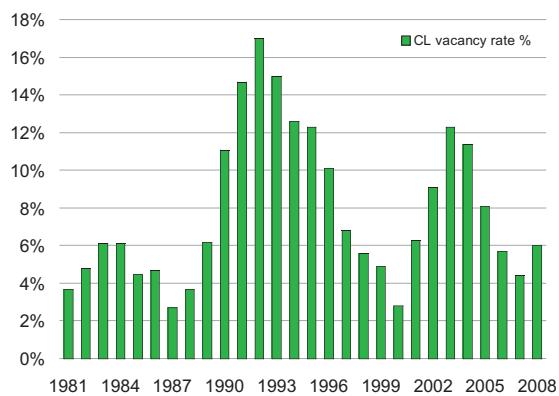
Spring 2009

“Vacancy rates will rise, but will peak at lower levels than those seen in either of the last two downturns.”

Take-up fell in 2008...



... and the vacancy rate rose to 6%



- Take-up fell sharply in both the City and West End in 2008.
- The central London vacancy rate rose throughout the year due to development completions rather than tenant returns.
- Headline rents have fallen by 20-30% from their peak levels, and rent free periods moved firmly in the tenant's favour.
- Investment volumes remained low, and yields have continued to rise. However, for some types of investment we believe that the bottom of the cycle is in sight.
- 2009 will see further rises in vacancy rates and falls in rents. However, this downturn will see lower peak vacancy rates than in previous cycles.

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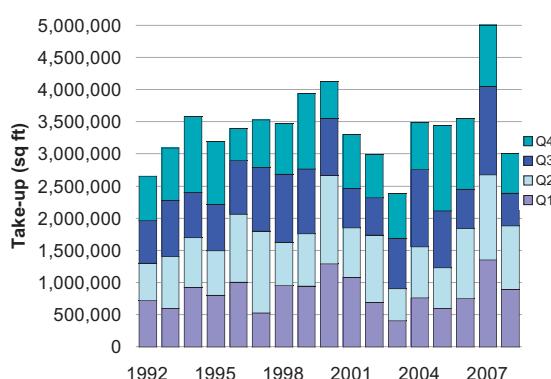
West End leasing and development

Supply & demand

While the second half of 2008 was a quiet one in terms of leasing activity in the West End, a strong December lifted the total take-up for the second half to 1.1m sq ft. This brought the total for the year to a marginally below average 3m sq ft.

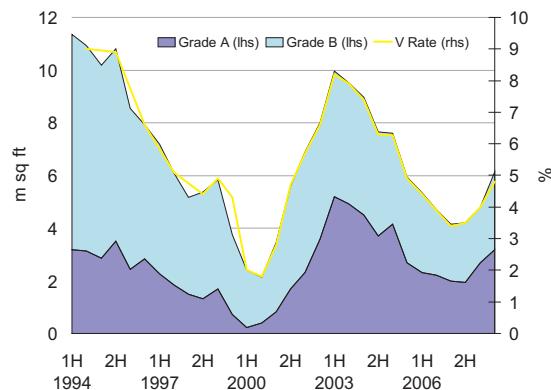
The Professions were the most active business sector in 2008, accounting for 20% of the space leased. One surprising outturn for the year was the continued strong demand from the Insurance & Financial Services sector, accounting for 13% of last year's take-up of office space in the West End.

Take-up was well down on 2007, but only marginally below the long-run average



Availability rose steadily throughout the year, though the vacancy rate was still very low at 5.1% at the end of December. 52% of the vacant space is Grade A, a reflection of the low levels of development completions across the West End.

The vacancy rate has risen to 4.8%



Given that much of the rise in vacancy in the 2003/4 downturn was due to tenants trying to assign or sublease space, an important indicator to keep an eye on in the current downturn will be the proportion of the availability that is tenant-controlled. While this has risen slightly over the last six months, it remains low at 38.5%. This is well below the peak of 53% in 2003.

Rents

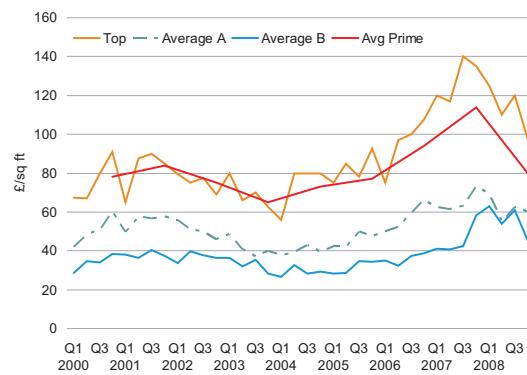
While the vacancy rate in the West End remains comparatively low, it is clear that the lower than average leasing activity has resulted in tenants beginning to have the upper hand in negotiations. The first half of 2008 was characterised by little movement in headline rents in the West End, but increasingly attractive rent-free periods on offer, led to falling net-effective rents.

The second half of last year saw headline rents begin to be affected, and we estimate the average prime rent achieved (the average of the top ten leasing transactions) fell from £114/sq ft at the end of 2007, to £80/sq ft at the end of 2008. This is a 30% fall in headline rents over the course of the last 12 months.

This sharp fall is a reflection of the Banking and Financial Services-led "ultra-prime" market for relatively small units in Mayfair and St James's. Elsewhere in the West End, where rents never reached the heady levels of over £100/sq ft, the trend has been rather less dramatic. As the chart below shows, both the average Grade A and average Grade B rent across the whole of the West End remain at much the same level as they were at the end of 2007.

This resilience in the wider West End office market is a reflection of the fact that many businesses remained relatively unaffected by the credit crunch. However, the UK economic recession is likely to have a dragging effect on the West End market in 2009.

Prime rents fell by 30% in 2008

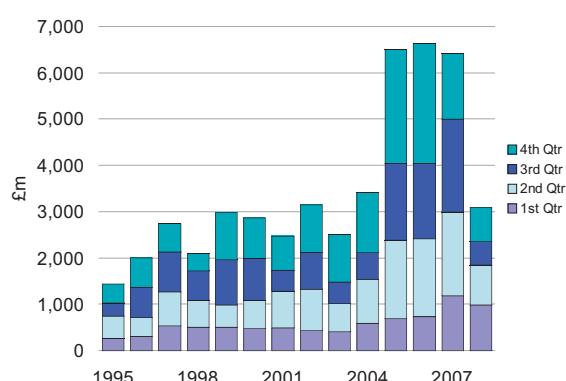


West End investment

The second half of 2008 was very much a continuation of the trends seen in the first half, with low levels of transactional activity, continuing problems in obtaining debt, and rising yields.

The total turnover for the year was £3.1bn, a dramatic fall in comparison to the boom years of 2005-2007, but as the chart below shows, broadly in line with the "normal" levels of the preceding decade. H2 was particularly muted. The myth of the West End being a defensive play by virtue of its occupational structure was shattered and, with values falling, demand evaporated. This translated into turnover of £1.2bn, the quietest six month period since the early 1990's.

Investment turnover fell sharply in the second half of 2008



Even with pricing by the year end on a footing with that of December 2004, above average yields and a healthy margin over swaps; the absence of debt and fears of (free!) falling rents, buyers have been content to stand on the sidelines.

Of those prepared to treat, International investors remained the most active purchasers of West End office investments, accounting for 57% of all purchases by capital value. Amongst this grouping the biggest net investors were from the Eurozone, a trend that we expect to continue now that the pound is at virtual parity with the Euro, thereby minimising the costs of hedging against currency risk for non-sterling denominated investors.

In the case of sellers, UK funds have unsurprisingly been the most dynamic, having been forced to react to not only investor redemptions but also actuarial demands to relocate capital to other asset classes. By the year end they had sold £1.78bn of stock (58% of total). UK plc's, the next biggest seller, felt pressure albeit for different and widely reported reasons and typical of this were the mixed fortunes of Land Securities who tried and partially succeeded with as

much as £400m of stock sold.

Yields

The lack of any meaningful transactions is making it very difficult to accurately assess how far yields have corrected over the last six months. According to IPD's December monthly index, the average initial yield on West End offices ended the year at 5.94%, compared to 3.97% December 2007 and 4.44% June 2008.

By our own measure, prime yields for 'rack rented' offices (whatever that means today) are currently around 5.75% and notwithstanding falling rents we expect these to remain steady. Secondary in contrast has already breached 7%, although in practice yields on most opportunities are already well above this when factoring in over-renting and variable income security.

Both prime and average yields have continued to soften, and there is now an attractive differential to the cost of money



Outlook

While it is still far too early to call the end of the credit crunch, we do expect 2009 to see a change in West End office investment market. The increasingly attractive yield gap and higher than long-term average yields are already beginning to stir some investors into activity. We expect that this year will see a pick-up in interest in smaller lot sizes with medium to long term secure income streams. There are unlikely to be many of these on the market, but those that do come to the market should attract significant investor interest, particularly from non-domestic investors. As a result of this, this relatively thin skin of prime, fundable investments should see yields stabilising or possibly even hardening slightly over the course of 2009. However, the bulk of the market, particularly anything with voids or potential voids, will see continuing falling values over the course of 2009 towards vacant possession value as what few buyers there are solely pricing assets on downside assumptions.

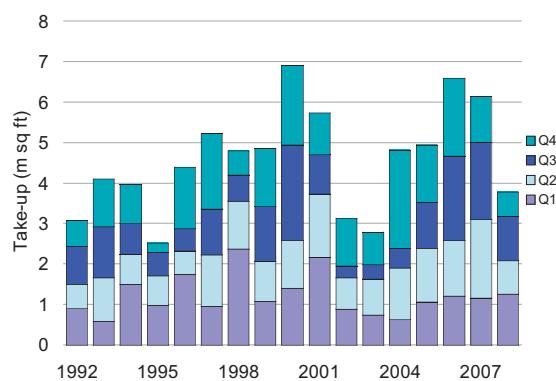
City leasing & development

Supply & demand

The continuing turbulence in the world's financial markets in the second half of 2008 led to significantly lower than average levels of take-up in both the third and fourth quarter of the year. The total take-up in the City of London in the second half of 2008 was 1.7m sq ft, bringing the total for the year to 3.8m sq ft. This is well down on both 2007's level, and the long term average of 4.4m sq ft.

In a reversal of the trend in recent years, only 49% of the take-up in 2008 was of Grade A space, a reflection of tenant's caution in the face of falling profits and pressures to control costs.

Take-up of City offices slowed sharply in the second half of 2008



Continuing the trend that we saw in 2007, the dominant business sector in the City office market in 2008 was the Professions, with the legal sector in particular remaining fairly active. 27% of the take-up was by the Professions, with the next most active sector being the Insurance & Financial Services sector at 20% of the total.

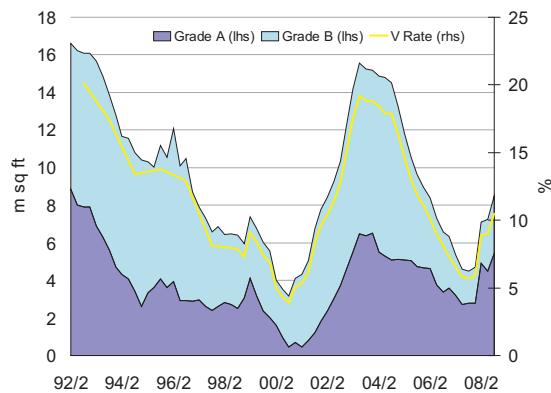
Given that boom and bust years in the City office market tend to be driven by the activity (or lack of it) of the Banking sector, it should come as no surprise that last year Banks only accounted for 11% of the take-up in the City office market.

A combination of speculative development completions and some space rationalisation by tenants has led to a steady rise in the City vacancy rate throughout the second half of 2008. By the end of 2008 we estimate that the vacancy rate had risen from 8.9% in June to 10.5% in December. This equates to 8.5m sq ft of office space on the market, 65% of which is Grade A.

The high proportion of the available space that is Grade A is an indication that much of the rise has been due to the delivery of speculative developments to the

market, and it is worth noting that our availability figure includes all developments due for completion over the next six months.

The City vacancy rate was 10.5% at the end of 2008

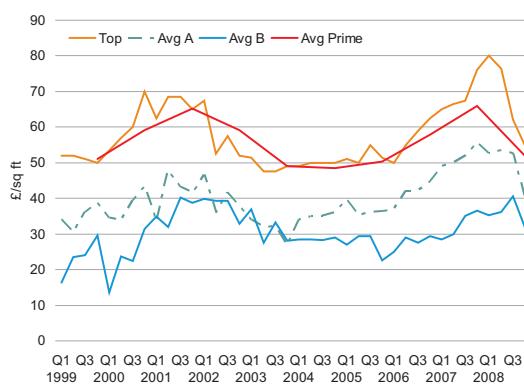


Given that the bulk of the vacant space in the last downturn was due to tenant cost-cutting, rather than development completions, it is worth noting that only 19% of the currently vacant space in the City is tenant-controlled. This may well be a factor that stops the vacancy rate rising towards the 20% level seen in both of the last market downturns

Rents

Following on from the falls in net effective rents in the first half of 2008, headline rents began to fall sharply in the second half of the year. We estimate that average prime rents fell by 21% to £52/sq ft over the 12 month period, with similar percentage falls across other grades.

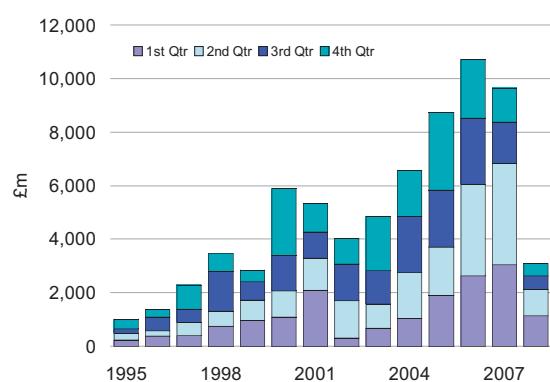
City rents have fallen by 25-30% during 2008



City investment

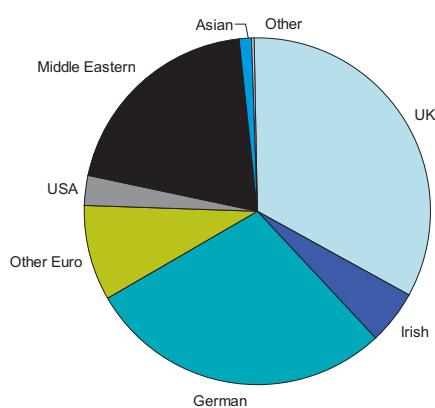
In 2008, turnover in the City of London investment market fell to its lowest level since the late 1990s. The second half of 2008 saw only £1bn of transactions, bringing the total for the year to £3.5bn. This dramatic turnaround is a reflection not only of the general lack of debt, but the fact that lot sizes in the City tend to be larger than elsewhere in the UK.

City investment turnover in 2008 hit its lowest level since the late 1990's



The primary vendors of City office investments last year were the Institutions, particularly those from the UK, who sold around £1.5bn in comparison to purchasing £170m. 67% of the purchases were by non-domestic investors, led by German and Middle Eastern investors.

International investors were the biggest buyers of City offices in 2008



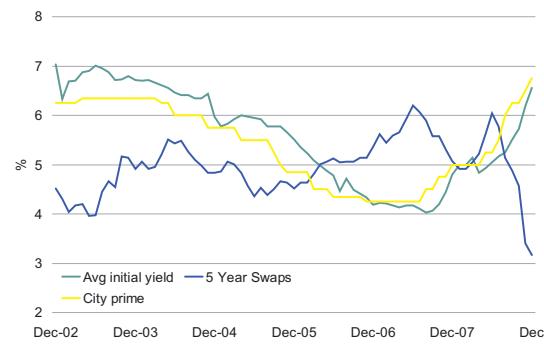
In the case of the German investors, who were primarily institutions, the fourth quarter was a quiet one as the open-ended funds in particular began to close to redemptions in the final three months of the year. As at the start of 2009 many remain closed, but continue to rate the long-term income and comparative yields in

London as a good reason to invest as and when their funds re-open. A further factor that is focusing all international investor's minds on the City of London and UK investment markets is the weakness of the pound against both the dollar and the euro.

Yields and outlook

Both prime and average yields on City offices continued to soften in the second half of the year, with the IPD indices showing an average initial yield of 6.56% at the year end, and our own prime index pointing to 6.75%.

City yields have continued to rise



Given that the long term average yield on prime City offices is 5.57%, this alone makes the market look attractive. Adding in the relative security of income, the declining currency risk, and the reversion of the yield gap with the cost of money, makes City of London office investment look increasingly attractive.

Clearly the prospects for the leasing market will raise concerns about covenant strength in some investor's minds. However, as the leasing outlook section of this report highlights, we believe that the majority of the rise in the City vacancy rate has already happened.

2009 will see the development of a two-tier market in the City of London. Secure income deals, particularly those in smaller, fundable lot sizes, will become sought after. However, these are even more scarce in the City than the West End, with only 20% of the properties in this market having 10 years or more left to run on the lease. Furthermore, many of these are large buildings which may prove problematic to finance in today's debt market. We expect capital values to stabilise or possibly harden on smaller, secure income deals, but to continue to fall (albeit at a slower rate) in the rest of the market in 2009.

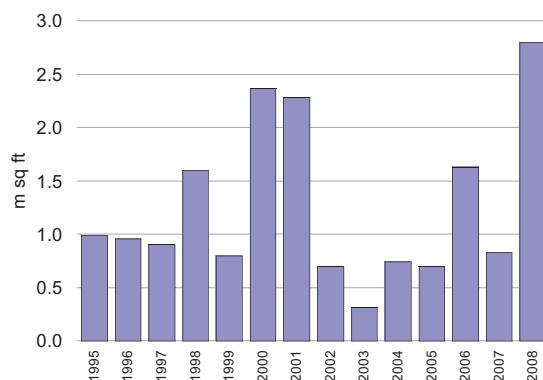
Docklands core

Supply & demand

Given the breadth and depth of the banking crisis, one might be forgiven for thinking that take-up would have been very quiet in the Docklands office market in 2008. Actually, the reverse has been true with the take-up for the year totalling 2.8m sq ft.

1.9m sq ft of this was due to the purchase of land with an option to build by JP Morgan in November, but even excluding this, last year was a strong year for the Docklands Core, with non pre-lets totalling 910,000 sq ft over the course of the year. This compares favourably with the long term average for this market of 960,000 sq ft.

Take-up was strong in 2008



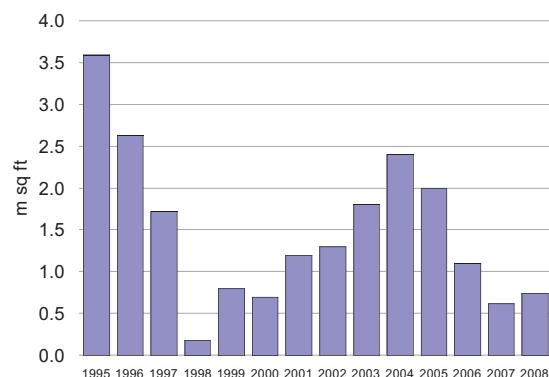
As usual, most of the take-up was focused on Canary Wharf, however there were a number of lettings at Harbour Exchange and on Marsh Wall, indicating that the Docklands market still has significant attractions to tenants despite the turbulence in the financial markets.

Looking back to the last downturn in the central London office market, the biggest issue in the Docklands Core was the return of tenant-controlled space to the market, and this time around it is clearly going to become an issue again. As at the end of 2008 the total availability in the Docklands Core had actually fallen to 746,118 sq ft from its mid-2008 level of 820,000 sq ft.

However, tenants such as Bear Stearns and Fitch have already returned space to the market and we believe that there are other businesses at Canary Wharf that are looking at sub-leasing or assigning space in the immediate future. In many cases this may not happen to the same degree as in the last downturn, primarily because the removal of the relief on empty rates now makes it less financially attractive for a tenant to put excess space onto the market, particularly when low levels of demand may mean that this space remains empty for a significant period.

Aside from the issue of "grey space", the strength of this market has always been its ability to control the state of the development pipeline to minimise the prospects of oversupply. As a result of this we do not expect the delivery of new space to the market to become an issue in 2009 or 2010.

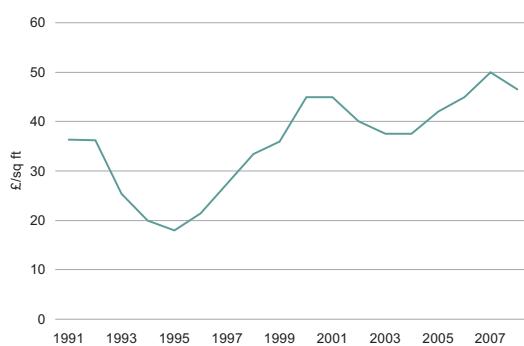
Availability remains low



As ever, the tone of the rents being achieved in the Docklands Core is hard to evaluate. Six months ago we stated that headline rents had stabilised at around £50/sq ft. Since then the best rent achieved at Canary Wharf was £46.50/sq ft at 25 Canada Square to Sungard in December 2008. We have no details on the rent free periods on offer to tenants at Canary Wharf, but would expect that they are in line with those on offer in the City i.e. 24+ months on a 10 year lease.

Outside the Wharf the movement in rents has been slightly downwards, with the best rents achieved in the second half of 2008 being around £30/sq ft.

Docklands Core rents fell slightly in 2H 2008



Outlook

The big questions for the central London office market in 2009 and 2010 are more related to the leasing than the investment markets. Firstly, there is the question of the demand for office space. Will the City see even more rationalising, and will the economic downturn begin to hit demand for office space in the West End? On the supply-side the questions relate to the state of the development pipeline, and whether we will see the same degree of tenant-controlled space released onto the market that we saw in 2003/4?

Starting with the question of take-up, it would be foolish to assume that demand for office space will recover in the face of continuing financial markets turbulence and an economic recession. Those tenants who are coming up to a lease event will have the choice of staying put and renegotiating their lease terms, or moving and taking advantage of falling rents and lengthening rent-free periods. Demand for office space never totally disappears in the central London office markets, and we believe that while few businesses are expanding in terms of headcount, there will be some who choose to take advantage of the state of the market to achieve very attractive terms on new or existing leases.

The City of London economy has already experienced a significant downturn, and we estimate that around 10% of the employees in the City have lost their jobs as a result of the current crisis. While it is unfashionable to be anything other than deeply pessimistic, we do not believe that the take-up level in the City of London will be any worse this year than in 2008.

The West End is a different story. Take-up in 2008 was relatively healthy, however the recession in the UK economy has not hit headcount in the West End to the same extent that the City was hit last year. West End occupiers tend to be more exposed to domestic rather than international trends, and as such we expect that take-up in the West End will be lower this year than last.

At present, our forecasts for take-up across central London are that it will remain below average in both 2009 and 2010, but return to average levels thereafter.

In terms of the drivers of rental growth, levels of availability are more important than similar percentage variations in take-up. Within the measure of availability, the volume of speculative development completions has more impact on the total than a similar change in the rate of release of tenant controlled space.

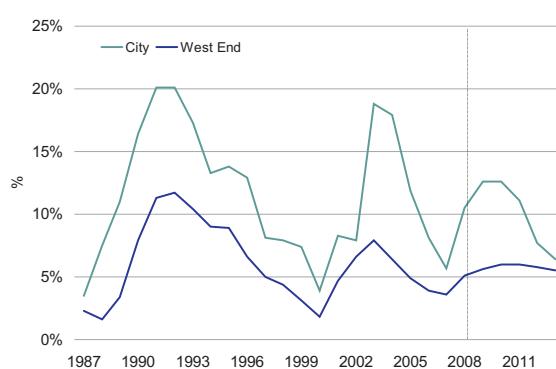
Clearly the City of London is in the throes of a development boom, with over three million square feet of speculatively developed space due to be delivered to the market this year. However, the increasing shortage of debt over the last 18 months has meant

that many development starts have been delayed. As a result of this, the volume of completions planned for 2010-2013 has fallen dramatically. This should ensure that the market does not see the same level of overbuilding that it saw in the late 1980's and early 1990's. Indeed, as the chart below shows, we expect the City vacancy rate to fall fairly fast from 2010.

While we do expect to see an increase in the volume of space that tenants are seeking to assign or sublease, again we do not expect this to rise to the same levels as seen in 2003/4, when more than 60% of the vacant space across central London was controlled by tenants looking to save costs.

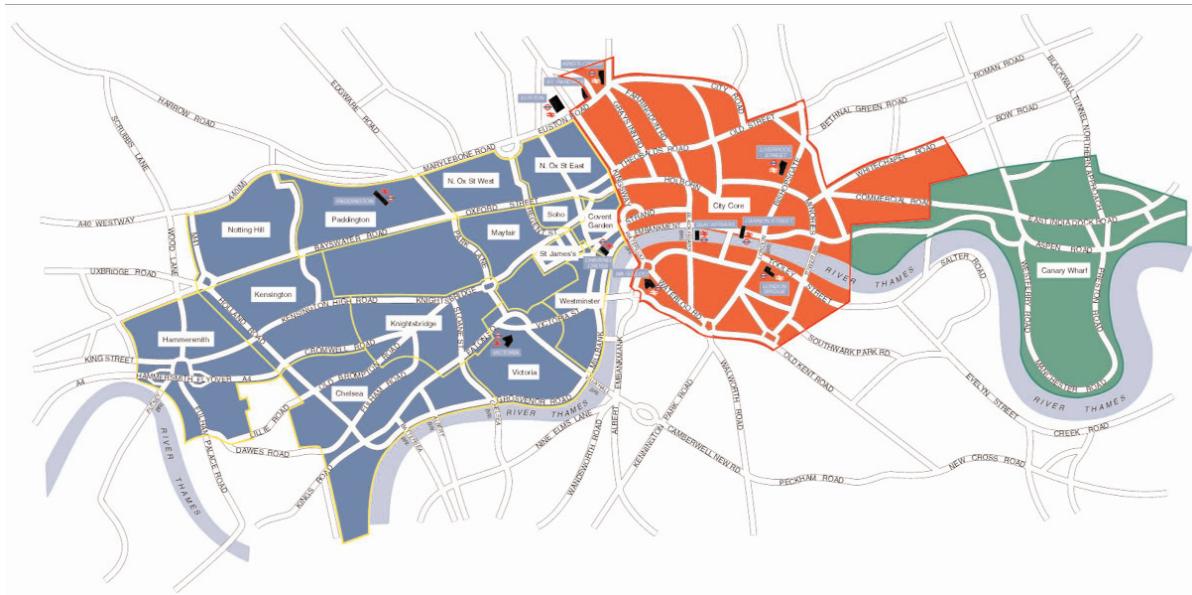
The rationale for this view is that at the start of the current downturn few businesses in central London were sitting in substantially under-occupied buildings. Indeed, the volume of requirements for overflow space in early 2007 indicates that many were at or close to full occupancy of their central London estates. As a result of this, even with the headcount cuts to date, there is relatively little "grey" space in many companies portfolios. Furthermore, the removal of the relief on empty rates makes it financially less attractive for a tenant to release office space onto the market for sublease or assignment than it was in the post-dotcom bust of the early part of this decade.

Vacancy rates will rise, but not to the levels seen in the early 1990's or early 2000's



Pulling all these strands together, 2009 and 2010 will be a period of below average take-up in the central London office market, with the West End feeling the bulk of the pain this year. Vacancy rates will rise, but will peak at lower levels than those seen in either of the last two downturns. Headline rents will fall throughout 2010, and we are currently projecting a peak to trough fall in rents of around 50% in both the City and the West End - however in both these markets the bulk of the correction has already happened. Rental recovery looks likely from late 2010 and this may be fairly rapid in the City of London.

Survey area & key contacts



Monthly market data

We also produce monthly data reports on the City and West End office markets. If you would like to receive this information on a regular basis then please email your request to moakley@savills.com

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