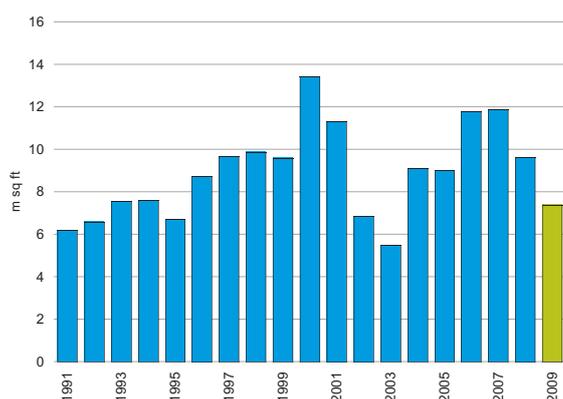


# Central London office review & outlook

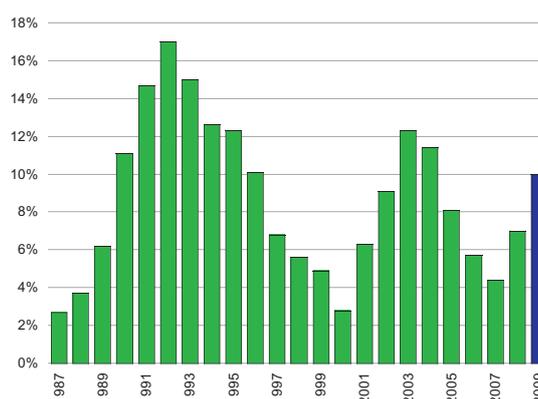
## Review of 2009 and outlook for 2010

**“2009 was the nadir of this cycle. 2010 will see a supply driven rental recovery in the City, which will be followed by the West End.”**

Take-up remained restrained in 2009...



... but the vacancy rate has peaked at 10%



- Take-up across all of central London's submarkets was lower in 2009 than in 2008. However, leasing activity in the second half of the year was significantly stronger than in the first half.
- Availability has now peaked, and vacancy rates fell in the final few months of 2009.
- Prime rents appear to have stabilised, and there is some evidence that net effective rents are rising.
- Investor demand remained strong throughout 2009, driving an average of a 100 bps hardening in prime central London office yields.

- 2010 will see a sharp recovery in the leasing markets. This will be driven by a shortage of Grade A supply, rather than a boom in demand. We expect most locations to see a rise in prime rents in 2010, with the City of London leading the pack.
- Investor demand for London offices is expected to remain strong in 2010. While we do expect to see more assets on the market, this will not be significant enough to stop prime yields continuing to fall. Investor's will broaden their focus as they become more comfortable with shorter lease terms, refurbishment and redevelopment opportunities.

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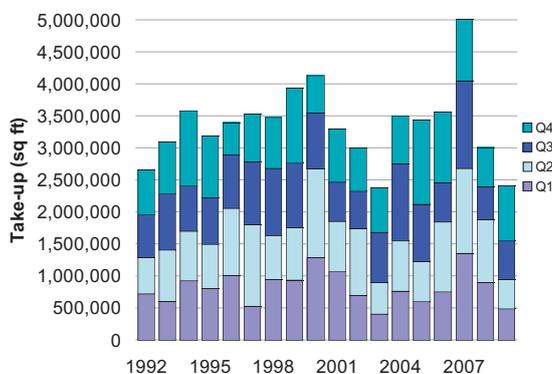
# West End leasing and development

## Supply & demand

Given the West End office market's close linkage to the health of the UK economy, we never expected demand for office space in 2009 to be anything other than heavily muted. Our expectations were correct, with the total take-up for 2009 only reaching 2.4m sq ft, despite a pick up in activity in the final quarter.

This muted level of demand was in line with the level seen at the bottom of the last cycle in 2003, and 20% down on 2008's total.

### West End take-up was 29% below average in 2009



Has demand for office space in the West End reached its nadir? Certainly, the pick up in leasing activity in the last three months of 2009 gives us some indication that tenants are beginning to feel more confident about the future. However, the economic recovery in the UK this year will be muted and this will continue to dampen demand for office space in the West End for the remainder of this year.

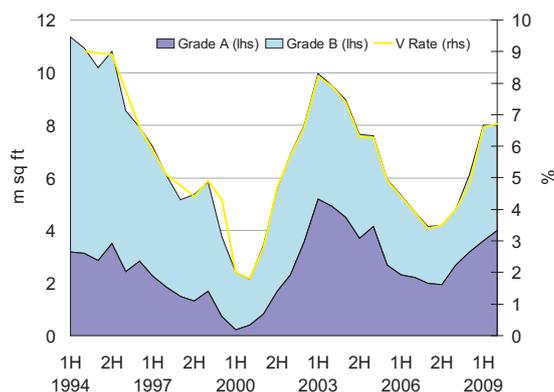
On the demand side there has been a slight pick-up in the levels of latent demand in the market, however we believe that the key driver of the West End office market over the next five years is going to be a shortage of Grade A supply, rather than a strong boom in demand.

The vacancy rate across the whole of the West End office market ended the year at 6.7% (equivalent to 8m sq ft of vacant space). This is well above its level at the start of last year (5.3% in Jan 2009), but still low in comparison to most other UK and European office markets. While around half of this vacant space is new or refurbished in the last decade, past cycles in the West End show that the trigger for upward rental growth is when vacancy rates begin to fall rather than a significant rise in leasing activity.

Sentiment is everything, and as soon as those tenants who have potential requirements for 2010-2012 begin

to perceive that availability is beginning to narrow, we will begin to see shorter rent free periods and then rising headline rents.

### West End availability stabilised in 2H 2009

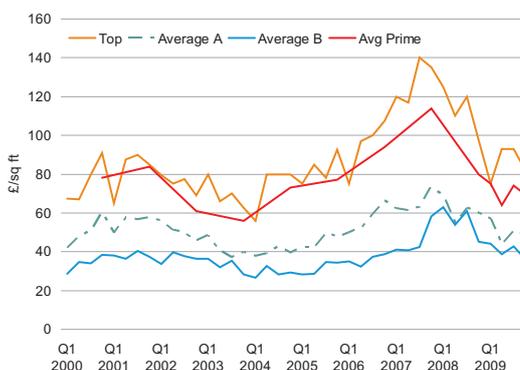


While the very restrained nature of the development pipeline is a well rehearsed line in our reports, it is worth reiterating that over 2010 to 2012 there is an average of 890,000 sq ft of completions per annum in the West End. This looks very low compared to a long term average of 1.8m sq ft per annum of completions, and 3.5m sq ft per annum of take-up.

## Rents

While the final quarter of 2009 saw a pick-up in leasing activity, this is yet to roll over into a rise in headline rents in the West End. We estimate that average prime headline rents in the West End fell by 20% during 2009, ending the year at £70/sq ft. On the net effective front there was some evidence that rent free periods shortened marginally in the final quarter of 2009.

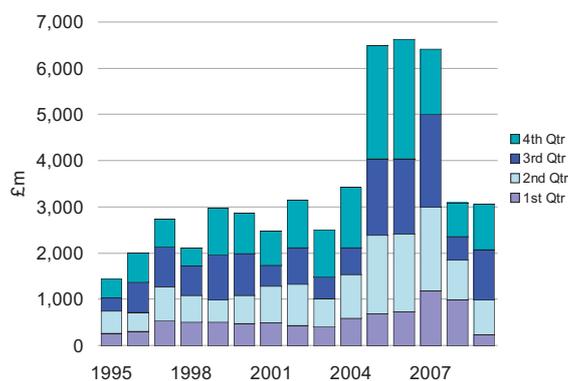
### Prime rents fell by 20% in 2009



# West End investment

Unloved and out of favour at the beginning of the year, West End property completed a full turn around by the year end, finishing as the preferred fashionable commodity the World knew and loved in 2005-2007. Turnover for 2009 recorded £3bn, respectably on a par with the previous decade's average after a strong H2.

## Investment volumes picked up sharply in the second half of 2009



Continuing the trend seen in the first half of 2009, non-domestic investors remained active participants in the West End office market, accounting for 62% of all purchases by value. Their focus continued to be relatively prime and secure income streams, continuing the "flight to security" that we commented upon in the first half of last year.

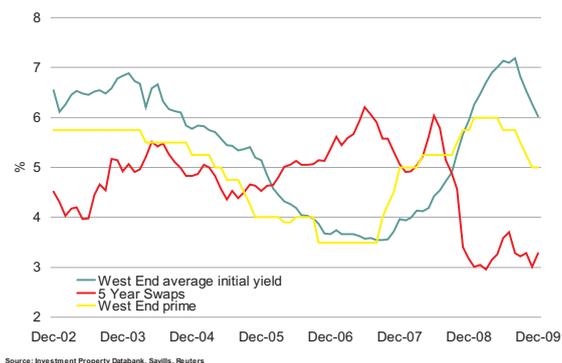
Another trend that was evident in the West End investment market in the second half of last year was a diminishing supply of product on the market. Our analysis shows that there were nearly a third fewer assets brought to the market in 2009 than in 2008 - a factor that undoubtedly contributed to the sharp falls in yields that were seen throughout 2009.

A final change that was seen in the second half of last year was the return of the UK institutional investor. In past editions of this report we have perhaps uncharitably referred to this segment of investors as typically late-cycle entrants, and as such we were not expecting them to return as buyers until late 2010 when the IPD indices supported their decisions. So although they remained overall net disinvestors some were early to latch onto the changing fortunes for rents and as such purchase volumes rose dramatically from £8m (Q1) to £300m (Q4) over the year.

The second half of 2009 saw further yield hardening in the prime market, with prime yields falling from 5.75% at the end of June, to 5.00% at the end of December. This brought the overall prime yield shift for 2009 to 100 bps.

The biggest change in the second half of the year was in average yields as measured by IPD's monthly index. These rose between January 2009 and August 2009, peaking at 7.19%. They then changed direction and began to fall sharply, finishing the year at 6.02%.

## Yields continued to harden



Clearly part of this shift in average yields was down to the movement in prime yields, but we also believe that it shows an increasing acceptance amongst investors that the bottom of the leasing cycle is close, making them more comfortable with shorter leases and voids.

## Outlook

2010 has already seen a swift response to the improvement in values with stock levels increasing dramatically. Many of these are traders. Despite an apparent rosy future for property, a number are keen to capitalise on a quick profit perhaps still believing worse economic news is still to come and the market more fragile than some predict. January has already seen 21 assets marketed totalling £530m; compared to 8 and a mere £88m the previous year.

In terms of demand, domestic institutional inflows are so strong they will have to feature heavily on the acquisition side over 2010. Over the course of the year we can expect them to dominate and outbid on key deals that will inevitably translate into strong evidence. An improvement in yields to 4% at least by the year end, if not sooner, is we predict on the cards especially given these buyers reliance on DCF's and the forecast for the performance of rents over the next 5 years. Overseas entrants that dominated in 2009 will to a point get crowded out, especially those that focussed on institutional deals unless they seek to secure a competitive advantage and target less liquid larger £100m deals. As the leasing market begins to show signs of recovery now well capitalised REITs and selected propco's will inevitably target the currently thin development market as they become more comfortable with voids and short leases even in fringe locations.

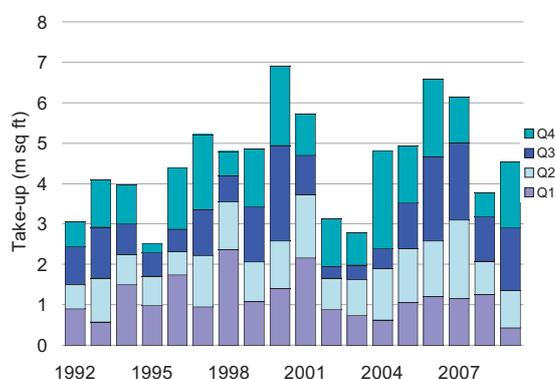
# City leasing & development

## Supply & demand

The City of London office market surprised on the upside in the second half of 2009 with two very strong quarters of take-up. Indeed, the monthly average take-up level more than doubled from 225,000 sq ft per month in the first half of last year to 532,000 sq ft per month in the second half of the year.

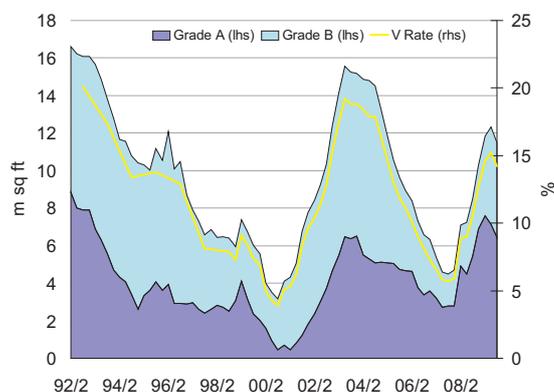
This brought the total take-up for the year to 4.5m sq ft, marginally ahead of the long term average for this market.

### Take-up recovered strongly in the second half



Why the strong recovery? In part, we can point to a recovery in confidence in the global financial markets, or at least a reduction in pessimism. However, looking at those tenants who took space in the second half of last year there was clearly an element of pent-up demand after two years of requirements being shelved due to economic conditions.

### The City of London vacancy rate began to fall in Q4 2009



Another factor that must have been lurking in the

minds of some tenants was the desire both to capitalise on a very tenant-friendly leasing market, and to avoid what might be a highly competitive market for Grade A buildings as the development pipeline really begins to tighten from late 2010.

The vacancy rate in the City of London has already begun to fall, ending 2009 at 14.2% overall (well down from its peak of 15.3%). However, this still means that there is nearly 11.5m sq ft of office space being marketed in the City, 56% of which is Grade A. So why are we beginning to see the signs of some urgency to acquire space amongst the City's larger businesses? The answer is clearly related to the state of the development pipeline.

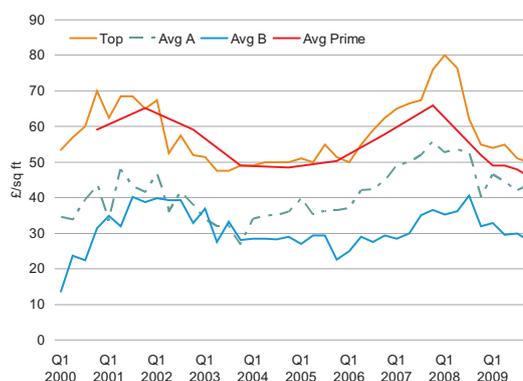
Over the period 2010 to the end of 2013 there is an average of less than one million square feet per annum of speculative development completions programmed for the City office market. Whether one compares this to a long term average level of completions (3m sq ft pa), or an average level of take-up (4.25m sq ft pa), it is clear that shortages of Grade A space are going to emerge fairly quickly in the City office market.

This shrinking pipeline and availability will undoubtedly drive a sharp rebound in headline and net effective rents.

## Rents

As 2009 ended, there was little evidence in the data of an uptick in headline rents, though the average prime rent at £46/sq ft had clearly stabilised in the second half of the year. However, the story at Drapers Gardens does indicate that some upward pressure on rents is beginning to emerge, with the space initially under offer at around £43.50/sq ft, and then subsequently under offer to Blackrock at £49.50/sq ft on a longer lease with a shorter rent free period.

### Upward pressure on rents is starting

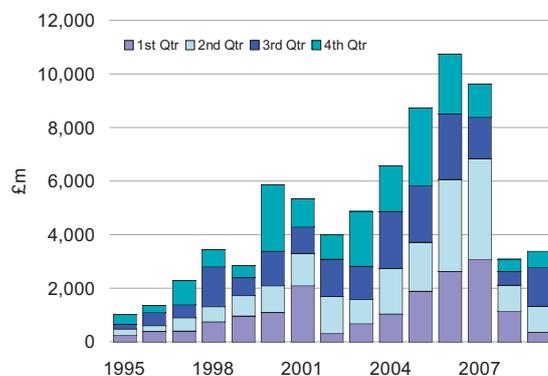


# City investment

The City of London investment market was restrained by a number of factors in 2009, most notably limited stock on the market and the larger lot sizes that characterise that market. Despite this, the volume of investment activity in 2009 at £3.4bn was marginally up on 2008's total.

The fact that turnover reached that level was pretty impressive, given that at the half year there had only been just over £1bn of transactions - the quietest six months since the mid 1990s.

## 2009 saw low levels of turnover despite the £1bn deal on Broadgate



Given that Blackstone's purchase of its stake in Broadgate accounted for more than one-third of the total capital value of last year's purchases it was inevitable that non-domestic buyers would dominate the statistics. Indeed, including that deal 90% of the purchases by value were by non-domestic investors.

Private domestic investors continued to be hampered by low LTVs and large lot sizes, and domestic pension funds and insurance companies also failed to make a single purchase in 2009.

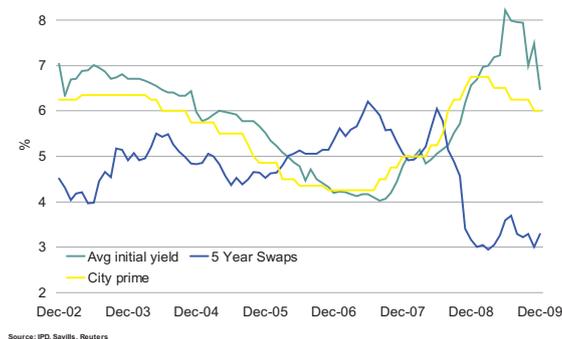
While the focus of the majority of buyers of City of London office investments in 2009 remained longer term income streams let to secure covenants (e.g. 88 Wood Street, 100 New Bridge Street), the second half of the year saw the beginnings of a recognition that the leasing market was stabilising. This renewed confidence in the leasing market quickly filtered through to some investors (particularly domestic property companies), and resulted in a resurgence in interest in shorter income deals that might represent refurbishment or redevelopment opportunities (e.g. 90 Queen Street, 1 Threadneedle Street).

While the UK pension funds and insurance companies did not purchase a single City office building in 2009, the major change in the final quarter of the year was the sharp increase in their interest in this market.

Clearly this renewed interest is being driven by the fact that not only is the City leasing beginning to recover, but many commentators expect that it will show the strongest rental and capital growth of any UK market as it emerges from the downturn.

The second half of 2009 saw a continuation of the trends in prime yields that we commented upon in the first half of the year. Prime yields hardened from 6.5% at the end of June to 6.00% at the end of December, bringing the overall correction in 2009 to 100bps. The more interesting trend in the final quarter of last year was the sharp turnaround in the average yield as monitored by IPD. This peaked at 8.22% in June 2009, before finishing the year 175 bps lower at 6.47%. Given that a "normal" gap between prime and average yields in this market tends to be 150-200bps, this clearly raises the question of whether prime is underpriced or average has over-corrected.

## Average yields closed the gap with prime



## Outlook

We see no prospect of a "double dip" in capital values in the City of London investment market this year. While some non-domestic investors will move on to cheaper pastures, this gap will be filled and exceeded by the return of the UK institutions to the market. So the only realistic trigger would be a dramatic increase in the amount of assets coming to the market.

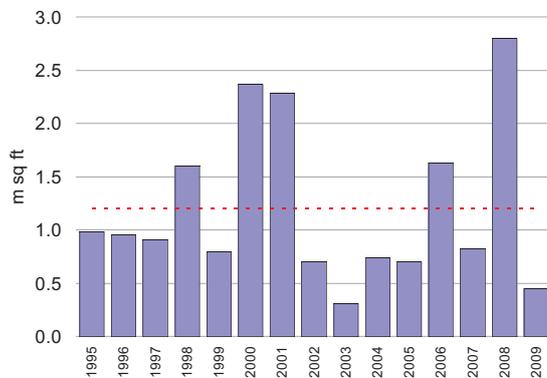
Certainly there will be some tactical sellers - both those who bought last year or in the middle years of the last boom. There will also be a pick-up in bank-led sales, both from within NAMA and banks closer to home. Will this be a large enough pick-up to lead to oversupply? In short we feel the answer is a resounding "no". The move away from a flight to security towards a flight to growth will make the City office market continue to look like a very attractive location for investors of any type. Some will still be held back by the lack of debt, but the rest will continue to drive selective yield hardening throughout this year.

# Docklands core

## Supply & demand

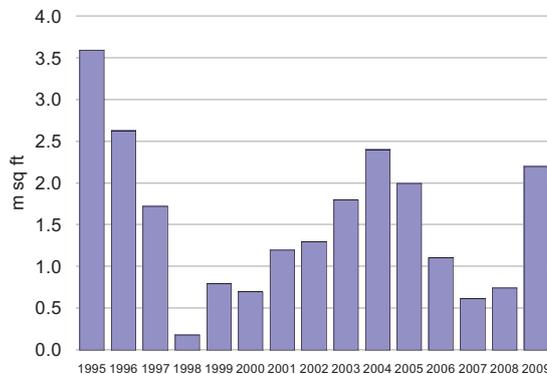
After the spectacular high of 2008's take-up (driven almost entirely by JP Morgan's acquisition), it was inevitable that 2009's level of take-up in the Docklands would disappoint. And at just under 450,000 sq ft for the whole of 2009 the trend was similar to that of many other central London submarkets, delivering the quietest year of leasing activity since the bottom of the last cycle in 2003.

### Take-up was very subdued in 2009



Despite the very quiet year in terms of take-up, some activity did begin to return to the Docklands market in the final few months of 2009. At the turn of the year nearly 500,000 sq ft of office space was under offer, 350,000 sq ft of which has already been completed during January 2010 in a letting to Barclays Capital Finance Ltd at 20 Cabot Square.

### Availability has risen close to its 2004 peak



This will clearly have a positive impact on the vacancy figures in the Docklands Core. However, as at the end of 2009 the vacancy rate had risen to 15.8%, a dramatic rise compared to its level of 5.1% at the end

of 2008.

Looking ahead, in a similar vein to the rest of the central London office market, the key factor for the Docklands Core is going to be the restricted development pipeline over the next three to five years. Indeed, at present there are no planned speculative development completions for that period. As Banking and Financial Services demand begins to recover in the City of London (as it already appears to be doing), the Docklands has always acted as a pressure release valve for the City market. With no new speculative schemes due for delivery in the Docklands over this period pre-letting will rise to the fore for those that can wait.

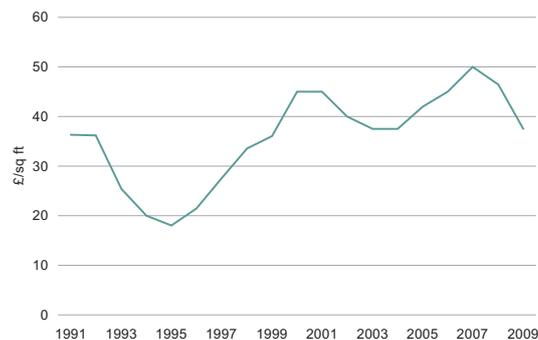
## Rents

After a 20% fall in prime rents in the first half of 2009, rents stabilised in the second half of the year at around £37-£40/sq ft dependent on lease length and inducements.

While the vacancy rate remains high the trend in 2010 is likely to be downwards due to the cessation of the development pipeline. As a result of this we do expect to see some upward movement in rents on smaller lettings of existing space at Canary Wharf. Looking outside Canary Wharf, tenant demand remains limited and letting evidence was scarce in the second half of 2009. Prime rents on South Quay and Marsh Wall remain at around £30/sq ft, though with limited demand and high levels of supply we expect these to continue to trend downwards during 2010.

A wholesale recovery in the Docklands market is likely to be closely linked to a recovery in tenant demand in the City of London. As such we expect Docklands rents to begin to recover strongly from 2011/12 when the availability of space in the City of London has become heavily constrained.

### Docklands rents fell 20% in 2009



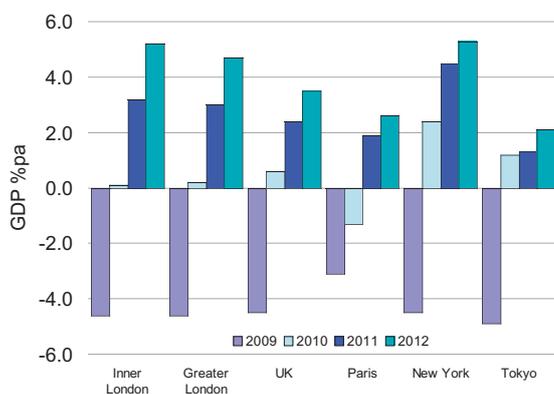
# Outlook

2010 will be the year that upward rental growth returns to the central London office market. However, the growth will be patchy and based on supply shortages rather than a dramatic increase in demand.

Starting with the demand side first, the outlook for both London's GDP and Financial & Business Services employment growth is positive (but only just) in 2010. This is particularly relevant for the West End office market where demand is closely linked to the health of the domestic economy. In the City of London office market, world GDP growth tends to be a better proxy for demand than UK GDP, and thus our take-up forecasts for the City in 2010 are rather more optimistic than those for the West End.

We deal with the medium to long term prospects for London in great detail in our recently released report "Emerging from Crisis: The prospects for London". In essence the report suggests that London's economy will begin to revert to stronger growth from 2011, and will be the fastest growing major financial centre over the period 2012-2020. While much of this output growth is forecast to be from productivity gains, it will undoubtedly result in faster rates of new business formation as well as net growth in employment across all office-based industries in London.

## Strong growth expected in the London economy from 2011



In the outlook section of our last report we highlighted the fact that in all of the last three cycles there had been a growth phase out of the bottom of the cycle when rental growth exceeded 15% per annum. Could this be achieved again, even in a comparatively low inflation environment?

Our latest forecasts for the central London office market indicate that the answer to this question could well be "yes", even against a short term background of comparatively low levels of output and employment growth. The key driver of this growth will be shortages of supply due to the almost complete cessation of

development starts from the middle of 2007.

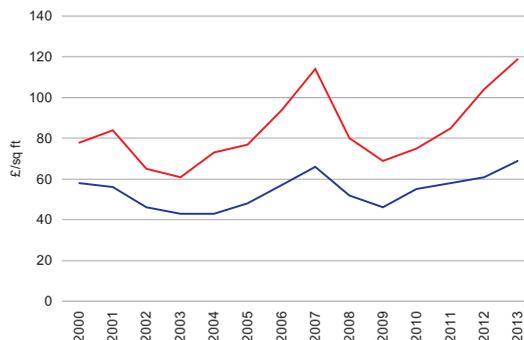
Central London office development completions are expected to fall to record low levels in 2010-2013 due to the lack of development finance that has been available. While some of the gap will be filled in by refurbishments that are started this year, it is clear that for larger tenants in the City who are looking for Grade A space, scarcity of suitable buildings is already becoming an issue. In the West End, because of the less volatile development pipeline, the scarcity of new stock will start to become an issue next year. However, with the comparatively low current level of vacancy in the core West End submarkets scarcity of smaller units in the most sought after locations could well become an issue in the second half of 2010.

What we are sure about is that pockets of undersupply of certain types of space are already beginning to emerge. It will be in these pockets that rental growth will begin to accelerate earliest, however muted the prospects for demand may be in 2010.

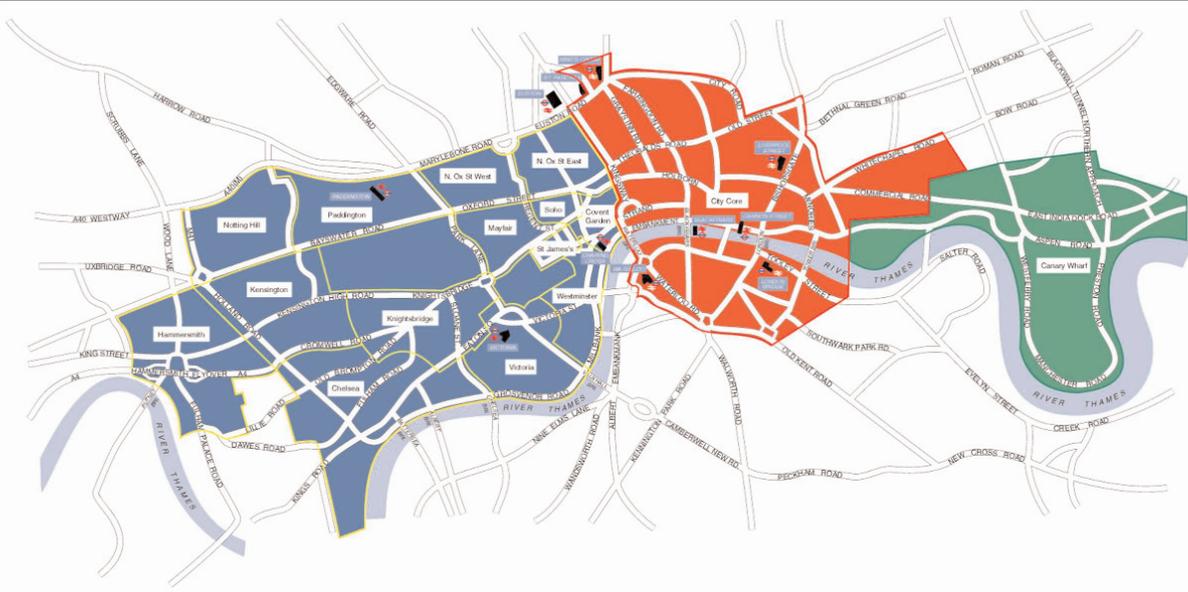
We expect that upward rental growth will emerge first in the City office market, primarily on 100,000 sq ft Grade A units where a supply and demand imbalance has already begun to emerge. This will wash over into the wider prime market in the City during the second half of 2010.

In the West End we are forecasting that once again the core Mayfair & St James's submarket will be the first location to see a recovery in rents, with the vacancy rate beginning to fall by Q2 2010 and headline rental growth being seen thereafter. For the rest of the West End submarkets, 2011 will be the year of a definitive recovery, driven by the combination of a firmer recovery in the UK economy and falling supply. By late 2011 we expect that all of central London's office markets will be firmly in recovery, delivering average Grade A rental growth of 8% per annum over the period 2010-2013.

## City rents to bounce in 2010, West End in 2011



# 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](mailto:moakley@savills.com)

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