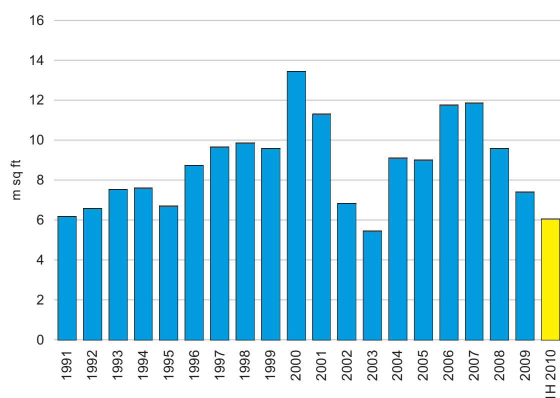
Central London office review & outlook

Summer 2010

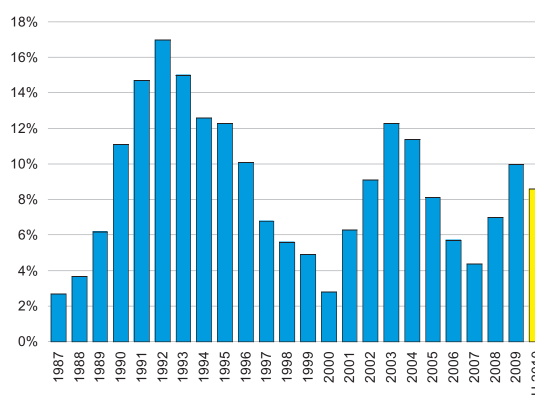
"Investors are increasingly focusing on rental growth, but will the central London office market deliver it?"

First half take-up almost exceeded 2009's full year total



- Take-up in the first six months of 2010 has almost exceeded the full year total for 2009. However, Q2 was quieter than Q1 and over the next five years we expect average levels of take-up rather than a boom.
- Vacancy rates have continued to fall in all of London's submarkets, with Grade A availability falling fastest.
- The second quarter of 2010 has seen prime rental growth beginning to emerge across central London. We expect that falling vacancy rates will continue to drive upward rental growth over the next five years.

The central London vacancy rate has now fallen to 8.6%



- Investor demand remains strong for smaller lot sizes with secure income streams.
- We expect to see continued downward pressure on prime yields over the next 6-12 months.

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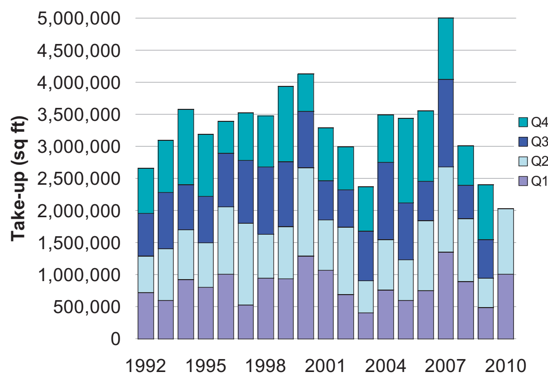
West End leasing and development

Supply & demand

Demand for office space in the West End has firmly picked up over the first six months of 2010, with the half year total of just over two million square feet being marginally ahead of the long-run average. While this is undoubtedly a positive trend, the figures are skewed upwards by a number of large lettings (three of over 100,000 sq ft this year). Overall, the actual number of leasing transactions remains well down on typical levels, and this is indicative of continuing recessionary caution amongst domestic businesses in particular.

West End take-up recovered to better than average levels in the first half of 2010



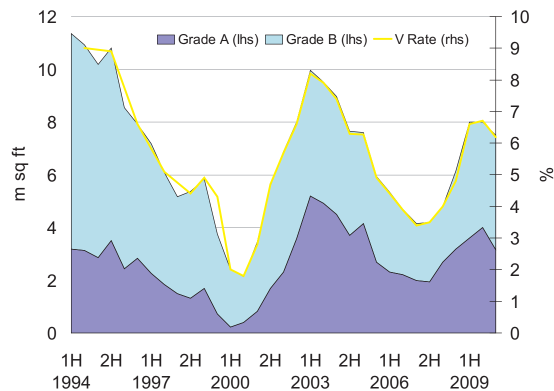
We expect that the third quarter of this year will be quieter, with many tenants choosing to defer decisions until there is more clarity on the state of the economy and the government's austerity plans in the Autumn.

Thereafter, we expect the tipping point between a tenant's market and landlord's market to be reached fairly quickly as tenant demand becomes more broad-based, and supply shortages become evident.

Availability in the West End continues to decline, albeit at a relatively gentle pace. At the start of the year the overall vacancy rate was 6.5%. This then fell to 6.1% by the end of the first quarter, and has subsequently risen to 6.2% due to several development completions.

The rise in total availability hides a fairly sharp fall in the availability of Grade A space in the West End, with the Grade A availability falling from 3.7m sq ft at the end of January 2010, to 3.2m sq ft at the end of June. In eight of the 14 West End submarkets that we monitor, less than 40% of the available space is now of Grade A quality. These will be the submarkets that lead the rental recovery in the second half of 2010 as tenants begin to compete for the dwindling supply of better quality office space.

Overall availability continues to decline, particularly of Grade A space

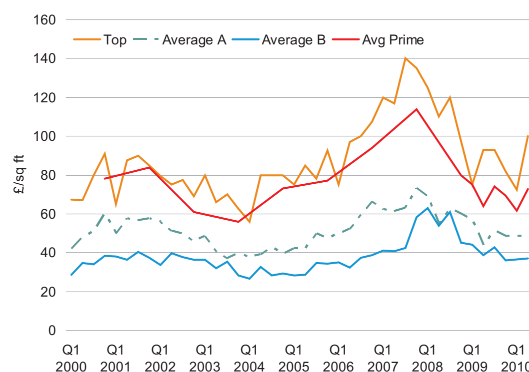


Given that there is only 414,000 sq ft of speculatively developed office space due for completion in the West End in 2011, the Grade A availability is likely to fall fast once the improvement in tenant demand has become more widespread.

Rents

While the bulk of the lettings so far this year have been in the £43-£50/sq ft range, there has been enough activity in the West End's core submarkets to drive a 5% rise in the average prime rent achieved across the West End in the second quarter of 2010. This was undoubtedly skewed upwards by the £100/sq ft letting to Prada at 40 Bruton Street, althought this reflects a dual office/retail use. However, we believe that there is clearly upward pressure on rents in Mayfair & St James's where Grade A availability is starting to become limited. Net effective rents are also rising, with the average rent free on a ten year lease now down to 24 months.

Average prime rents have risen by 5% in 2010



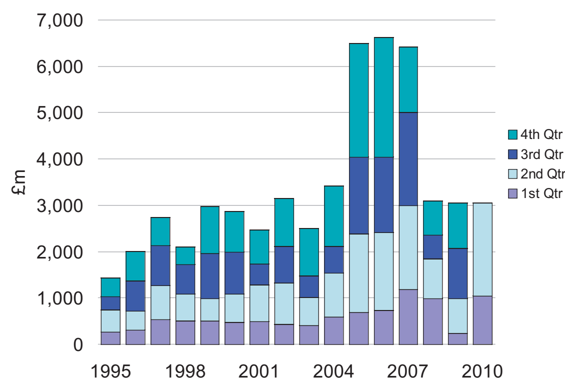
West End investment

The first half of 2010 witnessed a rapid response to the sharp rise in values of 2009, with substantial increases in both the supply of and demand for West End investment stock.

Rarely has the market seen such contrasting views. Whilst many buyers believe this is the beginning of the next growth phase; sellers have either taken an opportunity to capitalize on short term performance to 'flip' on recent trades or de-risk ahead of a potential 'double dip'.

These trends were converted into over £3bn of acquisitions and disposals and brought the total turnover for the first half of 2010 to an identical level to the totals for the full year in 2008 and 2009.

Back to the good old days? Turnover surged in Q2 2010



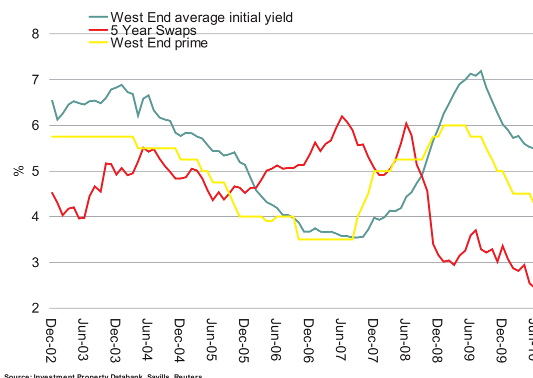
Whilst the turnaround in UK institutional sentiment was evident in the last quarter of 2009 it took until this year for their buying to make them overall net investors. This marked the first time since the heady days of 2005. In H1 domestic funds commanded a 25% market share and focused their deal activity in the £10-£30 million range making this probably the most competitive lot size range for buyers.

Non-domestic investors have continued to be significant players in the West End office market, accounting for 62% of all acquisitions and interestingly 48% of all sales. Key to the former was Middle Eastern money who took a near 50% market share of purchases and accounted for all three transactions over £100m in H1.

With so much competitive pressure from other sectors and value hard to identify UK REITS struggled to make any impact and therefore managed only 3 deals totaling a mere £85m

In such a strong buying environment it should be no surprise the trend in both prime and average West End office yields over the first half of this year has been steadily downward. At the end of June 2010 our prime yield tracker for West End offices stood at 4.25%, with IPD's average yield at 5.5%. In both cases this represents a fall of around 170bps from the trough of the market in 2009.

Yields have continued to harden in 2010



In terms of secondary yields few transactions offer over 6.5% as an initial return perhaps not surprising given the positive margin over 5 year swap rates.

Outlook

Although we have now seen six quarters of positive yield shift, and yields almost back to 2007 levels, investors have to date been disappointed by the promised return of rental growth. For those who entered this cycle early in 2009 their capital performance has been sufficient to compensate for this, yet recent purchases now rely on rental performance. Given the supply side dynamic to the occupational market this is a sure bet, it's just a question of when? But in the meantime investors may start to eschew the low yields vendors are demanding and already there is strong evidence demand from buyers has thinned since the spring. Could this warning sign be a precursor to something more serious or just a slightly earlier summer slow down?

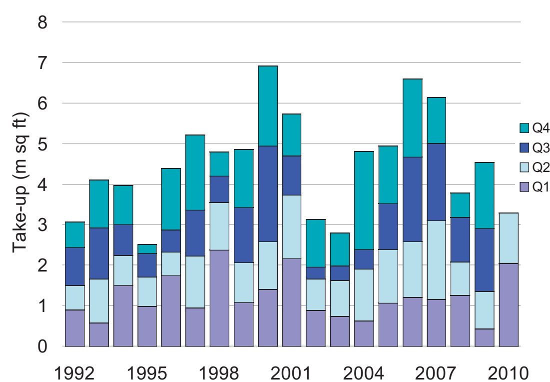
Right now we do not believe this hiatus is significant enough to result in values falling, but we do expect that average West End yields will remain stable until a stronger rental growth story emerges in early 2011. Of course there will be exceptions and smaller trophy purchases in both the retail and office sectors will continue to attract key money from cash rich overseas buyers and push prime office yields into the 3's but these scant deals are not to be regarded as representative of the market as a whole.

City leasing & development

Supply & demand

Following an exceptionally strong first quarter take-up of just over two million square feet, the City of London leasing market returned to a more normal level of take-up in the second quarter of 1.2m sq ft. This brings the total for the first six months of the year to 3.2m sq ft, the strongest first half of the year since 2001.

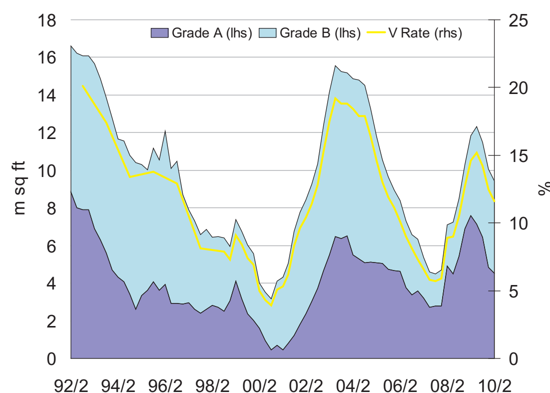
Strong first quarter take-up led to the best first half total since 2001



The summer months have seen an increase in procrastination as tenants are choosing to defer decisions until the autumn, pending more clarity on economic and market indices. Levels of requirements and the amount of space under offer indicate that the third quarter of 2010 is likely to see take-up more akin to the volume seen in the second quarter than the first.

On the supply side the picture continues to improve, with the vacancy rate now standing at 11.6%.

Availability continues to fall steadily



While this is significantly lower than the level seen at the trough of the market last year, there is still 9.4m sq ft of vacant space in the City of London, 48% of which is Grade A.

We expect that the rate of decline in the vacancy rate will accelerate in 2011 and 2012, when there is respectively only 897,000 sq ft and 591,000 sq ft of speculatively developed office space due for completion. In both cases this is substantially below the long run average level of three million square feet of completions per annum in the City of London.

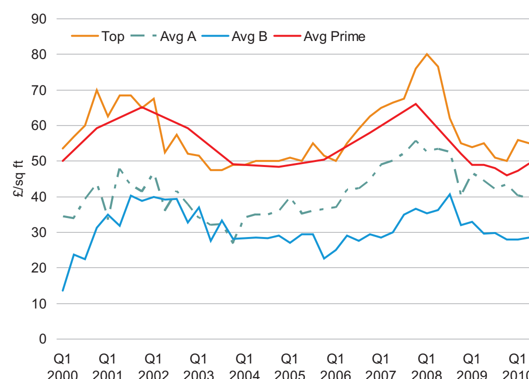
Rents

While the total level of take-up this year has been strong, the fact that much of it has been accounted for in larger lettings or pre-lets has limited the upward pressure on prime City office rents. Much of the smaller unit demand has been due to churn and has been driven by cost-sensitive occupiers, rather than those businesses who have historically tended to focus on trophy units in the City's signature office buildings.

As a result of this the growth in prime rents in the City of London has been relatively limited in the first half of 2010, with the top rent achieved in the second quarter of 2010 being £55/sq ft, and the average prime rent in Q2 standing at £49.25/sq ft. However, these levels represent growth of 7-10% over the first six months of this year, while average Grade B rents have remained stable over the last six months.

The biggest movement in rents over the last twelve months has been in prime net effective rents, where the shortening of rent free periods from 33 months to 24 months on a ten year lease has delivered annualised rental growth in the City of London of just over 20%.

Average prime rents in the City of London have risen by 7% in 2010

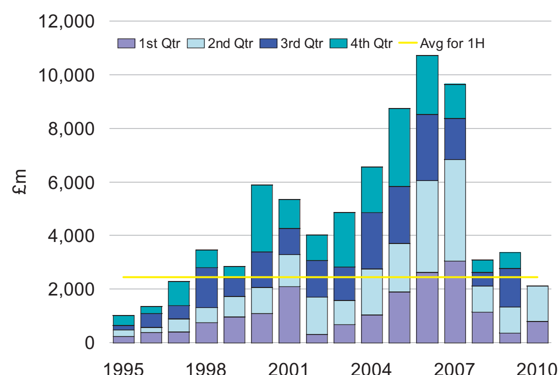


City investment

The City of London investment market saw a sharp increase in stock levels in the first quarter of this year. Indeed, at the end of that quarter we estimated that there was over £2bn of assets on the market. At that time there was some concern that this would destabilise the market, however the second quarter saw continued, albeit thinner, interest in City of London office investments, and prime yields have continued to fall.

Investment turnover rose to £1.3bn in the second quarter of 2010, bringing the total for the first half of this year to £2.1bn. As the chart below shows, this is only slightly below the historic average for the first half of the year, a pretty respectable performance given the very high levels in 2004-2007 that skew this average upwards.

Turnover in the first half of 2010 was broadly in line with the long-run average



The market in the first six months of the year was heavily divided by price bracket. Lot sizes of £100m and over remained saleable, but the lack of debt buyers in this price band reduced pricing pressure on the larger lot sizes. In the £20-50m band investor demand continued to far exceed supply, particularly for well-let assets with seven or more years income security.

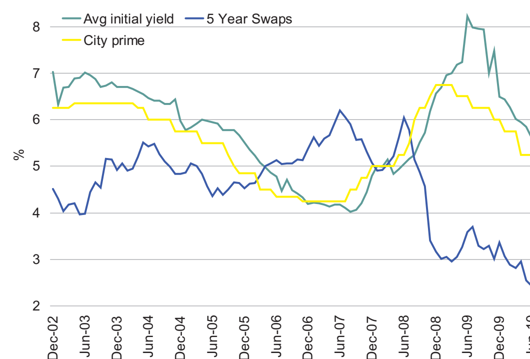
Following the surge in sales that we saw in the first quarter of the year, the majority of the better quality assets have now changed hands and there is renewed upward pressure on prime, fundable capital values. The key buyers of these assets remain risk-averse non-domestic investors of all types, and they have been joined by the UK institutions who are once again net investors in central London offices.

The well publicised impending shortage of new office developments in the City of London has caused a resurgence of interest amongst some investors in acquiring sites that are suitable for immediate development. However, these are incredibly scarce and we expect to see aggressive bidding for those development opportunities that come to the market in the next 18 months.

Another trend that has been apparent over the last six months has been a steady increase in the level of distressed sales by banks in the City of London. We estimate that 47% of all the sales by capital value this year have been by banks or special servicers.

Strong investor demand for smaller, prime lot sizes has driven prime City yields down to 5.5% in the second quarter of 2010. It is interesting to note in the chart below that the spread between our own prime yield index and IPD's average yield index for the City has narrowed considerably during 2010. This is probably a reflection of the shortage of prime assets that have come to the market at present, which is leading some investors up the risk curve in their hunt for exposure to the strong rental growth opportunity that is the City of London office market.

City yields have continued to harden, with the spread between prime and average yields narrowing significantly



Outlook

Looking ahead we expect investor demand for prime City investments to remain strong, particularly in lot sizes of below £100m. Risk aversion and rental growth prospects should support further gentle hardening in prime yields over the next 12 months. As we enter 2011 there will be a renewed focus on development opportunities and we expect a sharp increase in capital values for sites that are capable of redevelopment to capture the City office rent cycle.

Elsewhere in the market we expect to see a steady flow of distressed assets onto the market, with NAMA likely to be a major player in the market over the next 18-24 months. Improving rental growth should support demand for such assets.

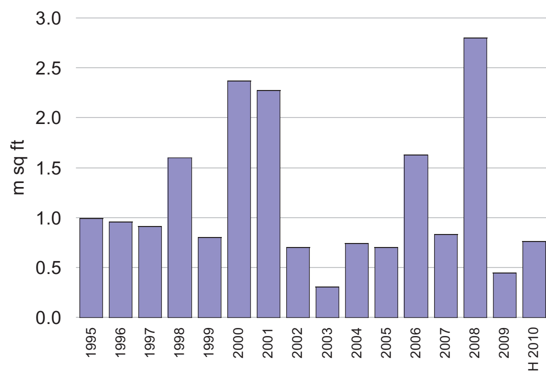
Docklands core

Supply & demand

As is usually the case, the Docklands office market has mirrored the tone of the City of London office market over the first six months of this year.

Improving financial sector confidence and the expansion of existing tenants at Canary Wharf were the primary drivers behind the rise in take-up to just under 760,000 sq ft over the first half of 2010. This is a pretty impressive level of take-up for this market, in line with the full-year total for a relatively normal year. One of the reasons for this strength was the Docklands Core market reverting to its normal ability to capture large cost-conscious tenants. 88% of this year's total leasing activity was accounted for by three lettings to Barclays Capital, Shell and LOCOG.

Docklands take-up was strong in the first half of 2010

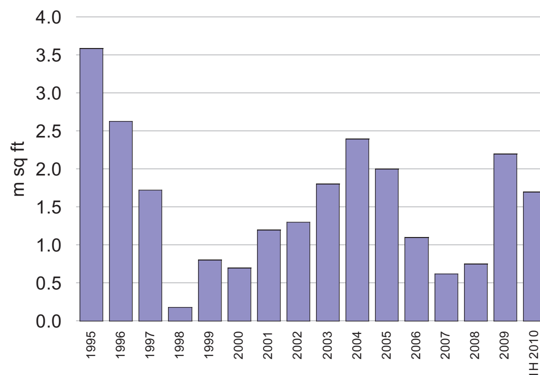


The strong level of take-up, and non-existent development pipeline have resulted in a decline in availability over the first half of this year. We estimate that the vacancy rate has fallen from 15.8% at the end of 2009 to 14.4% at present. Again, this is broadly in line with the trend in the City of London office market.

What is unique about the supply-side of the equation in the Docklands Core is the proportion that is of Grade A quality. We estimate that 81% of the office space available in this market is of the best quality, one million square feet of which is in four buildings on the Canary Wharf estate.

In any other submarket and phase of the cycle one might be worried about such a high proportion of the available space being of Grade A quality. However, given the likely shortage of Grade A space across central London over the next two to three years we believe that Canary Wharf might be in rather a strong position to capitalise on lease expiry driven, cost-conscious tenants in the future. Larger Grade A units are going to be in increasingly short supply in the City of London from 2011 and the rental differential between Canary Wharf and the City could start to look very attractive for some tenants.

Availability has started to fall in the Docklands Core

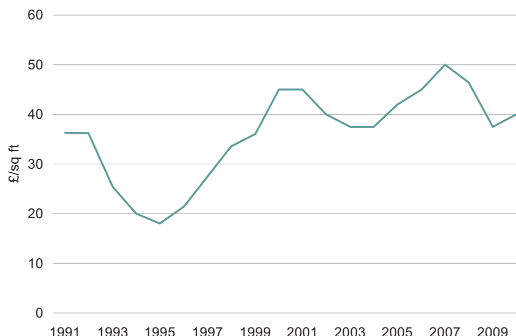


Prime rents in the Docklands Core ticked up in the first six months of 2010, from around £37/sq ft at the end of last year to their current level of £40/sq ft at 1 Canada Square. In the context of the rest of the central London market this is a respectable 8% rise.

Rents in the South Quay/Marsh Wall area have remained stable at £25-£30/sq ft for the best space, though we expect to see some growth in this area as the vacancy rate at Canary Wharf begins to fall sharply from 2011.

While there is still much debate about the future of the site that JP Morgan has optioned, the issue of whether they take this space or not is unlikely to dramatically impact the prospects for rental growth in the Docklands Core. We continue to expect a steady recovery in rents in line with those in the City of London.

Docklands rents have grown by 8% this year



Outlook

The recovery in central London's leasing markets has begun to emerge in the last quarter, but at present it remains very patchy and subject to derailment by economic or financial market instability. As far as the investment markets go, there is a clear sign that while the flow of non-domestic, risk-averse money into London remains unabated (London was the most active cross-border investment destination in the world by a factor of three in the first half of 2010), domestic investors are increasingly focusing on rental growth prospects.

So against a background of public sector austerity, sovereign debt issues and equity market turbulence, have the prospects for rental growth in the London office market weakened?

The supply side of the equation clearly has not changed much, indeed it might be possible to argue than property lenders have a number of reasons to be even less willing to lend on speculative office development in London or anywhere else. On that basis we remain of the view that 2011-2013 will remain a period of record low levels of development completions across central London.

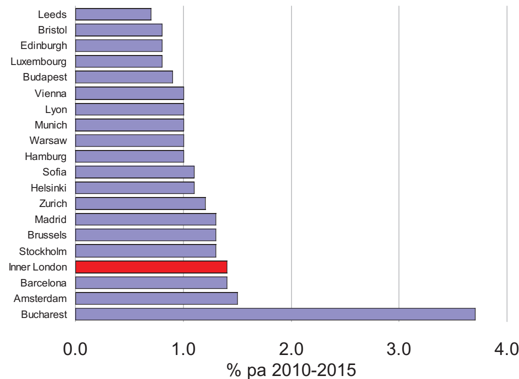
On the demand side the official statement of economic prospects for the UK has undoubtedly weakened over the last six months. However, the revised GDP and employment numbers from the OBR bring the official view more into line with our view that the UK is unlikely to return to trend growth until 2012/3. This has always been at the centre of our view of a very gentle recovery in the demand for office space over 2010-2012.

Lower output growth for the UK does impact on the prospects for London, but less so than for any other region. Furthermore, given that London is probably the best insulated region from a period of public sector austerity, we remain of the view that inner London will be one of the strongest growing cities in Europe in the short to medium term.

London's strength is relatively unique compared to its western eEropean peers, and is driven by its particularly strong private sector, as well as its strength as a global financial centre. According to the latest forecasts from Oxford Economics, Inner London will be the 8th fastest growing city in Europe between 2010 and 2015, with an annual average GDP growth rate of 3.5% per annum. Given that the only cities that exceed these levels are from the CEE or Scandinavia, this is an exceptionally strong forecast - albeit one of slower growth than London has been used to in previous economic recoveries.

As far as employment growth goes Inner London is projected to be the fourth fastest growing city in Europe, with an average annual growth rate of 1.4% per annum over 2010-2015.

Europe's top 20 cities by employment growth (2010-2015)

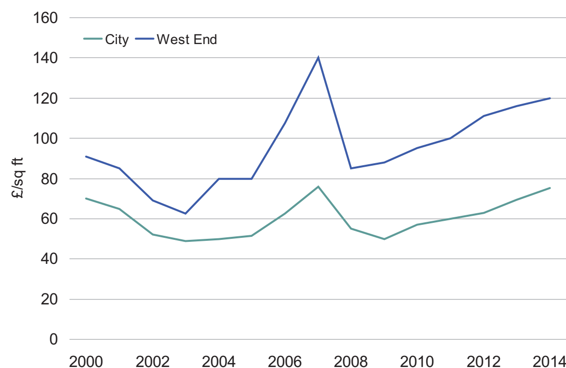


Source: Oxford Economics

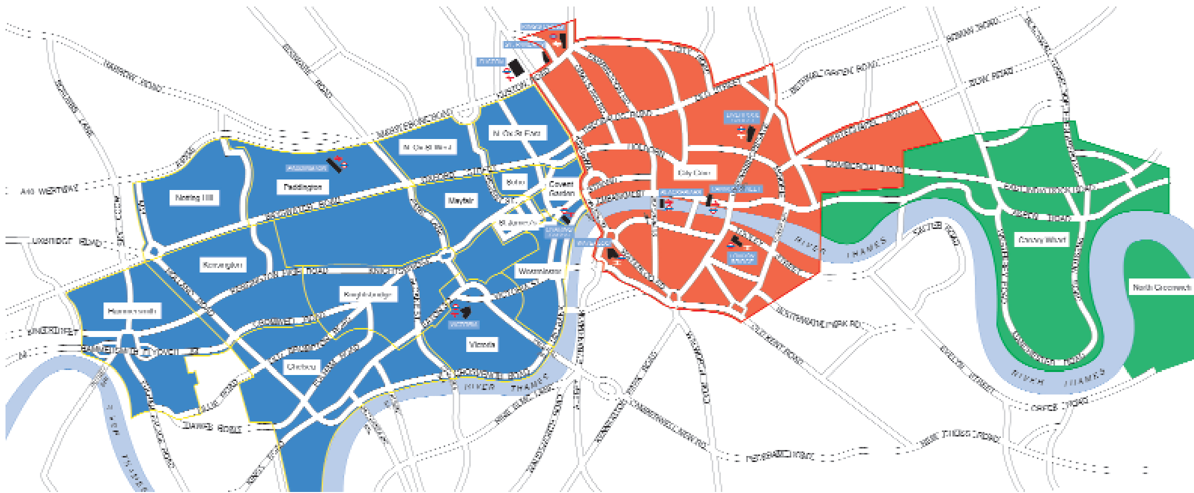
Against these relatively unchanged forecasts for GDP and employment growth, we remain of the view that take-up of office space is going to stabilise around long-term average levels over the next three to four years. Take-up will continue to be triggered by lease events, and London is facing a period of rising levels of lease events over the next two to three years.

The combination of gradually improving take-up and low levels of supply leaves our Grade A rental growth forecasts broadly unchanged from six months ago, with an average annual growth rate of 8.5% per annum in prime rents across the central London office markets. At a submarket level the rate of growth will clearly be influenced by the degree of undersupply present in that submarket. The strongest growth will once again come from smaller units in the City and West End core markets.

Shortages of Grade A space will deliver steady upward rental growth over the next four years



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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