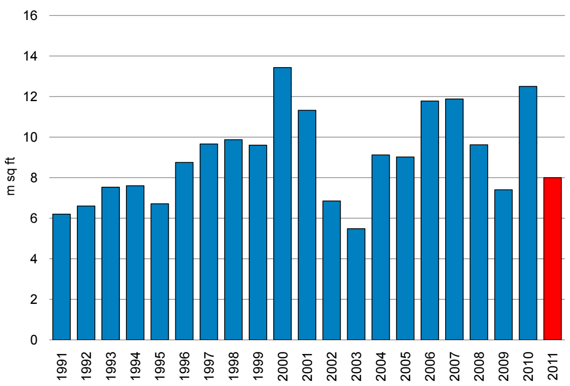
Central London office review & outlook

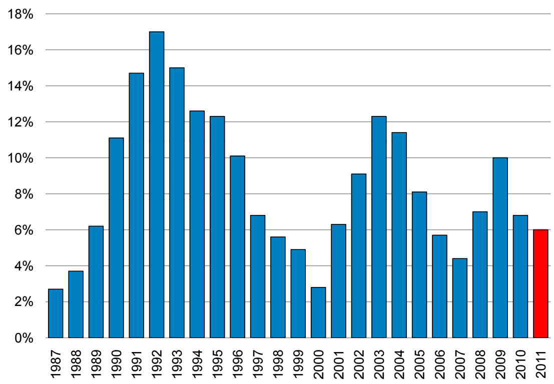
Spring 2012

“The key driver of rents over the next five years will be a shortage of Grade A availability rather than a particular bounce in tenant demand.”

Take-up was well down on 2010’s total, due to a decline in Finance & Banking activity...



... However, the vacancy rate continued to fall, and is now 6%



- Further turbulence in the banking sector led to another year of below average take-up in the City and Docklands. The West End, with its more diverse occupier base, saw a return to normal levels of tenant demand.
- Availability continues to fall across central London. While there has been a pick-up in refurbishment activity, we remain of the view that the next few years will see exceptionally low levels of development activity.
- Headline rents continued to rise in undersupplied markets and size bands. This will also be the tone for 2012/13.
- 2011 was another year of strong non-domestic investor demand for prime London offices. This will continue in 2012
- Prime yields were stable in 2012, and secondary and tertiary yields softened. There remains some downward pressure on prime yields.

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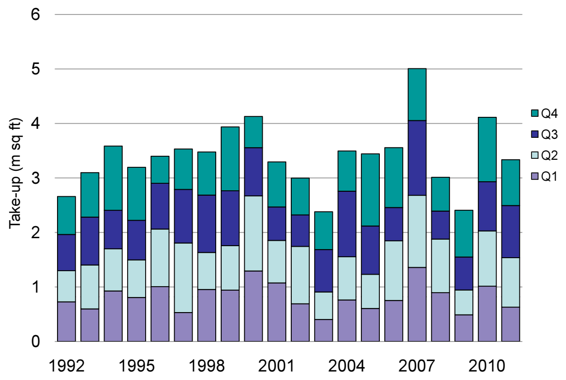
West End leasing and development

Supply & demand

It was no surprise that take-up levels in 2011 were well down on 2010, however it was reassuring that average levels of take-up were reached. 3.3m sq ft of take-up was recorded in 2011, this is in-line with the long-term average take-up figure in the West End. Against a back drop of weak GDP growth and negative occupier sentiment to achieve an average level of take-up is a relatively strong performance.

The West End's strength lies in its diverse occupier base and it not being reliant on one business sector to drive demand. The most active sector last year was Creative taking 18%, driven by five deals over 25,000 sq ft, the largest of which was 105,000 sq ft to NBC at Central Saint Giles.

Take-up reached average levels at 3.3m sq ft

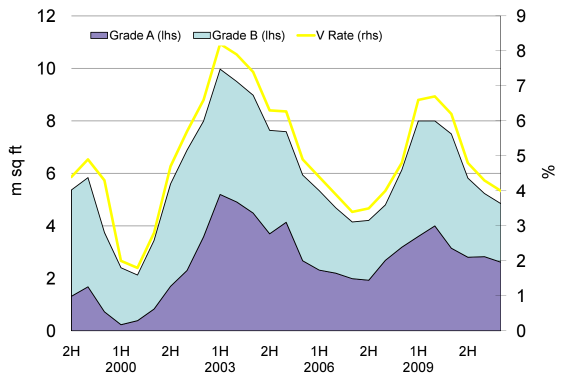


The undersupply of large Grade A floor plates in 2011 saw a pick up in pre-letting activity. Just nine buildings over 50,000 sq ft were available at the end last year compared with 14 a year ago. In total 7 pre-lets were recorded last year, on average just 5 per annum are seen across the West End. Pre-letting activity stands at 11% of total development pipeline over the next 4 years (2012-15).

Over a 12 month period supply levels fell by 17% and stand at 4.8m sq ft. This is a vacancy rate of 4%, indicative of a market which is undersupplied. On a submarket level, 11 out of 14 submarkets in the West End have less than two year's supply. When we look at Grade A supply in particular this increases to 12 out 14 submarkets with less that two year's supply and six out of 14 have less than one year's supply.

This supply squeeze should ease slightly as we go in to 2012/13 as development activity recovers slightly. Although still down on the long term average of 1.8m sq ft per annum, development levels have recovered and over the next four years (2012-15) delivery will average 1.4m sq ft per annum, up from 0.9m sq ft 12 months ago. Despite this, development funding still remains relatively scarce, which has led to landlords refurbishing their properties. Indeed 16 out of the 24 developments due for completion this year are a comprehensive refurbishment as opposed to a new development. As a result Grade A supply stands at 54%, with the majority of Grade A units entering the supply figures in 2011 being refurbishments.

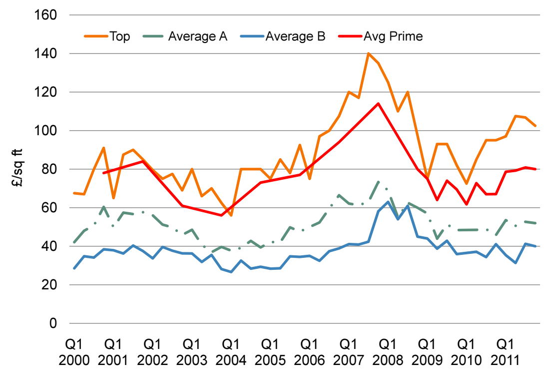
The vacancy rate ended the year at 4%



Rents

The highest rent achieved in 2011 was £107.50 per sq ft at 1 Grafton Street, Dering Capital having taken 2,293 sq ft at the Hines scheme. This and four other deals in excess of £100 per sq ft, all in the <10,000 sq ft size band helped average prime rents rise by 13% in 2011. This signifies the undersupply currently being experienced in Grade A small suites and which will continue in to 2012. We estimate average prime rents to rise by 12% next year and 6.5% per annum over the next five (2012-16) as the development pipeline recovers.

The top rent achieved in 2011 was £107.50 per sq ft

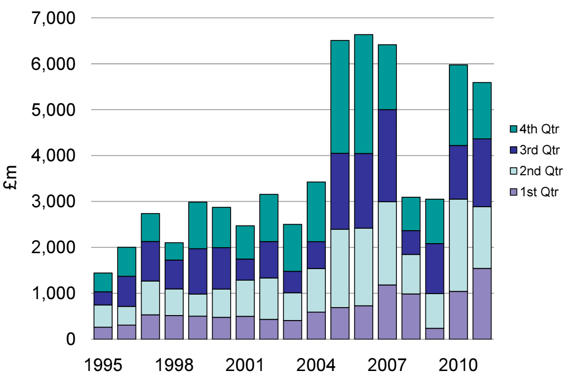


West End investment

The second half of 2011 was very typical of previous years with a traditional end of year flurry of transactions that led to a strong outturn for 2011 of £5.6bn (2010 £4.8bn).

As the chart below shows, this makes 2011 one of the five strongest years in the last 20, at least in terms of total transactional activity.

Investment activity continued to rise in 2011



The major difference between last year, and the preceding four years of the downturn was the pickup in the number of larger transactions. 15 deals over £100m or over were recorded, of which 82% by volume were by overseas investors. This clearly reflects the deepening non-domestic demand for West End property investments.

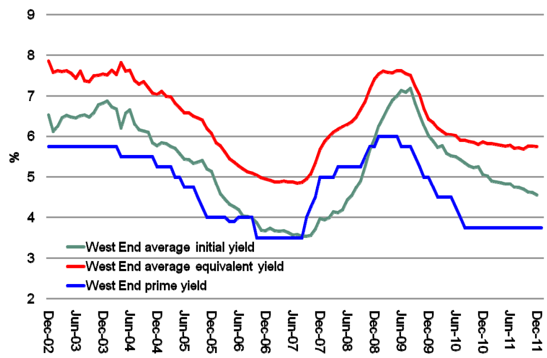
In contrast "local players" were net disinvestors from the West End once again, continuing the inexorable sell off of West End assets that has been ongoing for 13 of the last 17 years.

Yields

We have now kept prime office yields at 3.75% for over 12 months, and whilst this degree of stability feels inherently wrong in the context of the wider market, there is no doubt demand for "perfect" assets is stronger than almost anytime before from an ever widening international pool of buyers.

The average yields indices from IPD are broadly supportive of a degree of stabilisation in West End office yields, with average initial yields hardening slightly over the second half of 2011 (to 4.55%), and average equivalent yields broadly flat at 5.75%.

Prime and average yields remained stable in the second half of 2011



Source: Investment Property Databank, Savills

Secondary assets, or perhaps those of little appeal to the market-makers, seem increasingly likely to face upward pressure on yields despite a robust leasing market as debt becomes increasingly harder to obtain. That said getting a yield of over 6% on any freehold sale in the West End unless it sits on the fringe or offers risk (short income and/or capital expenditure) is still a challenge. Only 3 of a total of 166 were recorded in 2011!

Outlook

The outlook for the West End investment market in 2012 will depend as much on external as local issues. The higher than normal volume of non-domestic investor interest in this market in the last four years has been down to London and the West End's much repeated "safe-haven" status. Clearly this level of demand will be sustained as long as commodity price, equity market, political and economic turbulence continues. Arguably, even if these change, the ever diminishing stock of prime West End assets will still be in very short supply.

The local factors are potentially more dependable. Will prime West End office and retail rents rise over the next five years? Yes, they will and while the growth may not be stellar, it will be better than just about all other markets.

When considering the growth prospects of secondary no comments would be complete now without a reference to the demand from the residential sector for the conversion of offices. Last year as many as 15% of all purchases were bought for such use. In 2012 we can expect an extension of this trend, which of course applies as much to prime as secondary.

City leasing & development

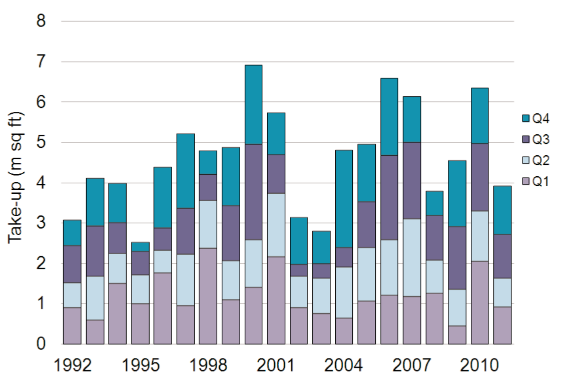
Supply & demand

Perhaps unsurprisingly, the economic uncertainty has led a number of larger occupiers to delay major decisions and 2011 was relatively quiet, with the total take-up figure ending the year at 3.9 m sq ft. This is 38% down on the same time last year, although only 16% down on the long-term average. Despite Cameron McKenna's withdrawal from negotiations on 200,000 sq ft at Principal Place, space under offer still stands at around 650,000 sq ft.

The main reason for limited take-up in 2011 was a lack of lettings over 50,000 sq ft with only 6 deals completing in this size bracket compared to the long term average of 17 deals per annum.

The smaller deal dominated take-up in 2011 with deals under 25,000 sq ft accounting for 81% of take-up. Interestingly, the volume of deals below 25,000 sq ft were up 30% on the long term average and at the highest levels since our records began.

Take-up ended the year at 3.9 m sq ft



Supply now stands at just over 7 m sq ft, with the vacancy rate finishing the year at 8.8%, which is still the lowest vacancy rate since July 2008.   Due to the Shard entering the supply figures Grade A supply has increased and now stands at 57% of current supply. However, it is worth noting that brand new buildings make up only 29% of this, with the rest made up of refurbished space.

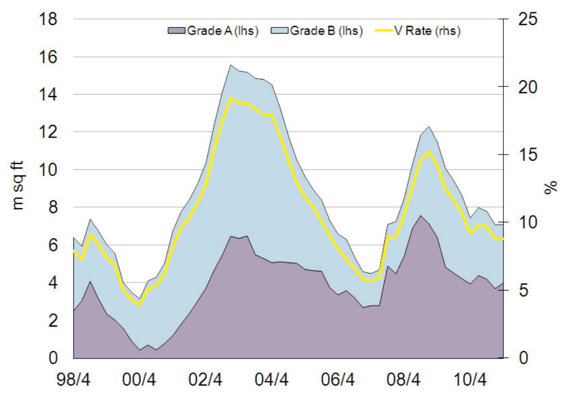
The City is currently undersupplied at the small & prime end of the market and this will move into the larger end of the market once Cannon Place and the Walbrook begin to let as we go through 2012. However, the increased refurbishment activity will fill in some of the supply gaps, although this is unlikely to have an impact on the larger end of the market which will remain under-supplied as we go through 2012/13.

As we move through the year, the biggest reason for relocation for many firms will remain "Lease events". The lack of available space combined with an exceedingly constrained development pipeline, should be a catalyst for increased pre-letting activity. AON taking space at 122 Leadenhall Street in 2011 was evidence of a large occupier signing up for space ahead of their lease event in 2014/15..

Although the impending lease breaks and expires will help improve take-up figures, we need to ask the question - how much of an impact will the number of companies relocating out of second-hand buildings, have on the amount of refurbished space which comes on to the market in the next two to three years? Will this contribute to a substantial rise in the vacancy rate?

The next round of redundancies in the Banking sector may also have an substantial effect on the number of second hand returns coming back to the market. With JP Morgan already putting space back on the market, we believe it is inevitable that other banks will follow suit, although with most banks close to capacity the amount of space that is returned should hopefully be limited.

The City is currently undersupplied at the small & prime end of the market



Rents

A rent of £67.50 per sq ft was achieved at the Heron Tower at the very end of 2011, where Engelhard Metals took 5,300 sq ft, however, it is worth noting deals over £60 per sq ft have generally been on towers during 2011 and predominantly in lettings below 15,000 sq ft, where the lack of Grade A space is more pronounced. .

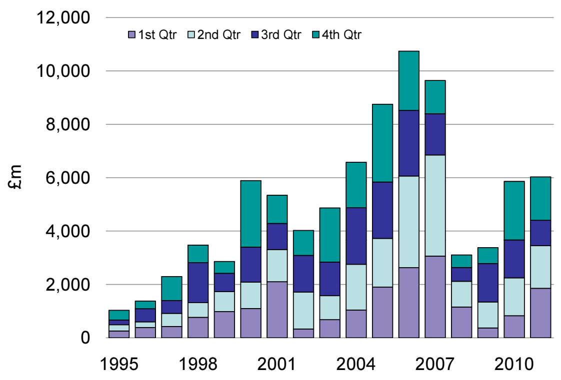
With seven lettings over £60 per sq ft this has helped push up Prime rents by 7% since 2010 and we estimate average prime rents to rise by 4.8% next year and 3.2% per annum over the next five (2012-16), assuming Grade A supply remains restrained.

City investment

The City of London investment mrket continued to prove popular in 2011, with a larger volume of transactions than the West End. In common with the West End the City also saw a rising volume of non-domestic investment last year.

The overall volume of turnover in 2011 was marginally up on the previous year, at £6bn. As the chart below shows, this is well above the long term average and made 2011 the fifth strongest year in the City investment market in the last 22 years.

City investment turnover rose in 2011



64% of this total turnover was purchased by non-domestic investors. This is above average compared to previous years. While this broadly appears to mirror the recent trends in the West End, the character of the non-domestic investor in the City is different. International buyers in this market tend to be sovereign or state investors who are looking to invest in large secure lot sizes that might not be available in the West End.

That having been said, it wasn't just large transactions that drove the market last year, with only 16 deals of £100m or over (compared to a five year average of 17). It was in the £50m and below bracket that there was most activity, as well as some of the keenest pricing.

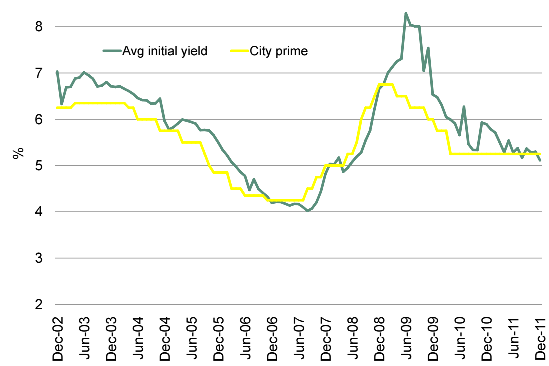
While the UK institutions are largely yet to return to the City office market, a mix of non-domestic privates and property companies were active both in the prime and secure end of the market, and on some more opportunistic deals.

Yields

It was on the smaller lot sizes that we saw some of the sharpest yields in 2011, reflecting their appeal to non-domestic private investors unwilling to pay low yields in the West End. While we maintained our prime City office yields at 5.25% for much of last year, there is some evidence that yields of below 5% are now achievable (and not just on smaller lot sizes). For example, .60 Threadneedle Street was sold for £186m at a yield of 4.75%. This keen price reflects the depth of demand that is currently in the market for assets that offer performance through rental growth and require no immediate capital expenditure.

Away from prime there is evidence of significant yield softening at the secondary and tertiary ends of the market. Yields in the 7%-9% bracket are now the tone for more complicated assets, and such assets that are priced more aggressively than this are failing to find buyers..

Prime and average yields remain stable



Source: IPD, Savills

Outlook

2011 demonstrated that there is significant depth of demand for City of London office investments, regardless of the short issues affecting the banking community. Headlines speculating that £5bn of stock coming onto the market would lead to a double dip in City values have been disproved, and we estimate that 80% of this has now sold or is under offer. The market is seen as offering growth potential in the medium term given the highly constrained development pipeline, and this coupled with historicially low yields in the West End. Furthermore, there is currently a shortage of genuinely available investments at all lot sizes.

We expect that 2012 will see more of the same. Prime yields, particularly on smaller lot sizes will harden. Demand for larger, prime lots will be supported by risk-averse global funds, and secondary assets will only sell if priced correctly.

There will continue to be a steady flow of bank-led sales, and this will be enough to keep the volume of turnover in the market above average. However, we do not expect it to exceed that of 2011.

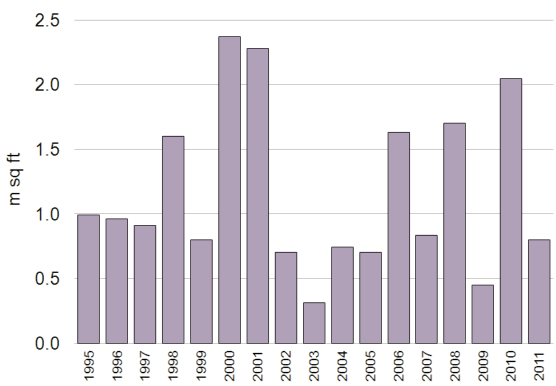
Docklands core

Supply and Demand

Although take-up for the first half of the year was 87% down on the long term average, the Docklands office market made a come back in the second half of the year, partly down to the 250,000 sq ft pre-let to at 25 Churchill Place European Medicines Agency (EMA) in August. EMA took just over half of the building with an option on another four floors. The agreed rent in the 20-storey building was £46.50 per sq ft, on a lease beginning 1 January 2015. This is the best rent achieved in Canary Wharf in 2011. Not only did this have a positive impact on take-up but it will help kick start the development pipeline with the rest of the space (250,000 sq ft) being built speculatively.

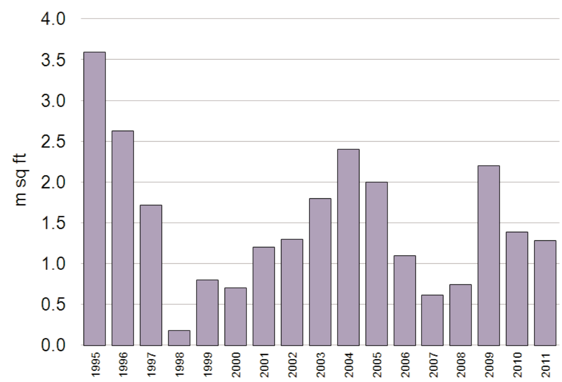
Take-up finished the year at just over 700,000 sq ft, 44% down on the same time last year, however, only 14% down on the long term average. 90% of these lettings happened in the second half of the year, with four deals over 50,000 sq ft making up 68% of take-up. Aside from the EMA deal, the three other lettings over 50,000 sq ft were a 75,000 sq ft letting at 191 Marsh Wall in December, a 67,000 sq ft letting at 6 Harbour Exchange in October and a 58,000 sq ft letting at 4 Harbour Exchange in September. This is the opposite story to the City of London leasing market in 2011, where the smaller end of the market dominated take-up.

Take-up picked up in the second half of 2011



The strong level of take-up seen in 2010, and the non-existent development pipeline has resulted in a decline in availability over the last two years. The vacancy rate has fallen from 15.8% at the end of 2009 to 8% at present. Although this isn't down to pre-2008 levels, this is broadly in line with the trend in the City of London office market. With the only development this year being 25 Canada Square alongside a steady flow of lease expiries, we expect the vacancy rate to continue to fall as we go through 2012. However, this may increase as we go into 2013 as c,600,000 sq ft of tenant space is rumoured to be coming back on the market.

Supply continues to fall

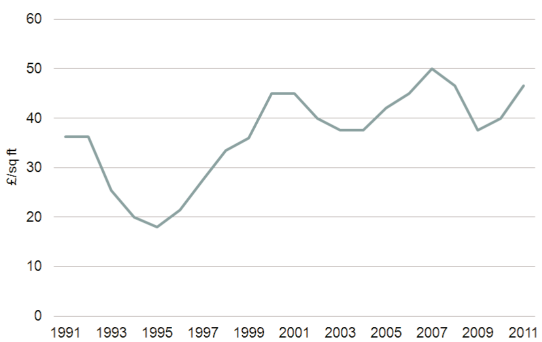


Looking towards to long term future supply, January 2012, saw the Canary Wharf Group take control of the 16.8-acre Wood Wharf site, in a £90m deal. Canary who already owned a 25% stake in the project, has now bought Ballymore's 25% share and British Waterways' 50% stake. The semi-derelict 16.8-acre site next to the London Docklands estate has an approved outline plan for 4.8m sq ft of mixed use space, resulting in six commercial buildings providing 4.9 m sq ft of office space.

Although there has been some rental growth, with EMA pre-letting at 25 Churchill Place signing at £46.50 per sq ft, a 16% growth on the best rent achieved in 2010, the general tone of the Docklands market is that rents have remained fairly stable through 2011, Looking outside Canary Wharf, tenant demand remains limited and letting evidence was scarce in the second half of 2011.

Prime rents on South Quay and Marsh Wall remain at around £30 per sq ft, though with limited demand and high levels of supply we expect these to continue to trend downwards during 2012.

Rents have remained fairly stable through 2011



Outlook

The overriding theme of market comments in 2011 was one of pessimism overcoming reality. The City was apparently in freefall, but away from the 50,000 sq ft and above market take-up was exactly in-line with trend and headline rents rose. The West End was supposedly hit by worries about the Eurozone, yet take-up was in line with the long term average and rents continued to rise. Some occupiers have deferred leasing decisions, yet others are quietly pushing ahead with requirements and taking advantage of cautious landlords offering great terms.

So has the recovery in the London office market really stalled, or gone into reverse, or have we just forgotten that recoveries are always bumpy? Certainly the investor demand and trading volumes that have been seen in London over the last two years don't point to any particular worry over the central London office market's rental growth prospects.

Assuming that the Eurozone doesn't slide into mass default, and drag down the US, UK and China with it, we remain reasonably sanguine about the demand for London office space over the next five years. Banking is undeniably going through a crisis of confidence at the moment, yet insurance companies, business services, telecoms media and technology companies are all in reasonably robust health. Indeed, non-financial companies in the UK now have the largest net cash balance that they have had in the last 30 years. This means that when their optimism improves they can be quick to expand and invest.

We remain of the view that take-up will recover to average levels, with a heavy bias towards Grade A space. Businesses seldom trade down in terms of quality when they move, even if they do reduce the quantum of space that they occupy. Furthermore, as the economic recovery gets underway we will see a renewed focus on the building as a tool to attract and retain staff.

We also continue to believe that the key driver of rents over the next five years will be shortage of Grade A availability rather than a particular bounce in tenant demand.

So, has the story on the supply side changed over the last 6 months? In short, not really and certainly not for the worse. Over the period 2012-2015 11 million square feet of development and refurbishments will complete. This is an average of 2.75m sq ft per annum which is well below London's long term average of 4.75m sq ft per annum.

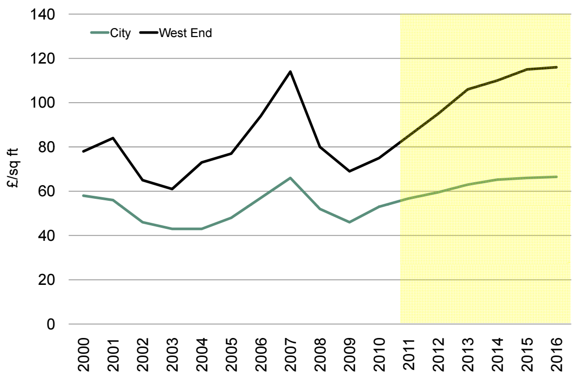
With the current financing environment unlikely to change, we do not expect to see a pick-up in development activity in the foreseeable future. However, a pick up in tenant returns is more likely. The biggest source of tenant returns will undoubtedly be the government's rationalisation of its own central London estate. According to figures from the Government Property Unit (GPU) the government occupies ten million square feet of offices in central London, 57% of which is leasehold. The GPU's aspiration is to reduce occupancy by 45-50% over the next decade.

Clearly the potential return of five million square feet of office space to the West End office market should not be ignored. Our view is that a considerable number of these units will be redeveloped for residential uses, or refurbished for office use. However, this volume of returns will be enough to slow the decline in the overall West End vacancy rate (though not the Grade A portion). However, with the overall West End vacancy rate now at 4% this won't be a drag on prime rental growth prospects. When half of the West End's submarkets have less than one year's supply of Grade A space, upward rental growth is inevitable.

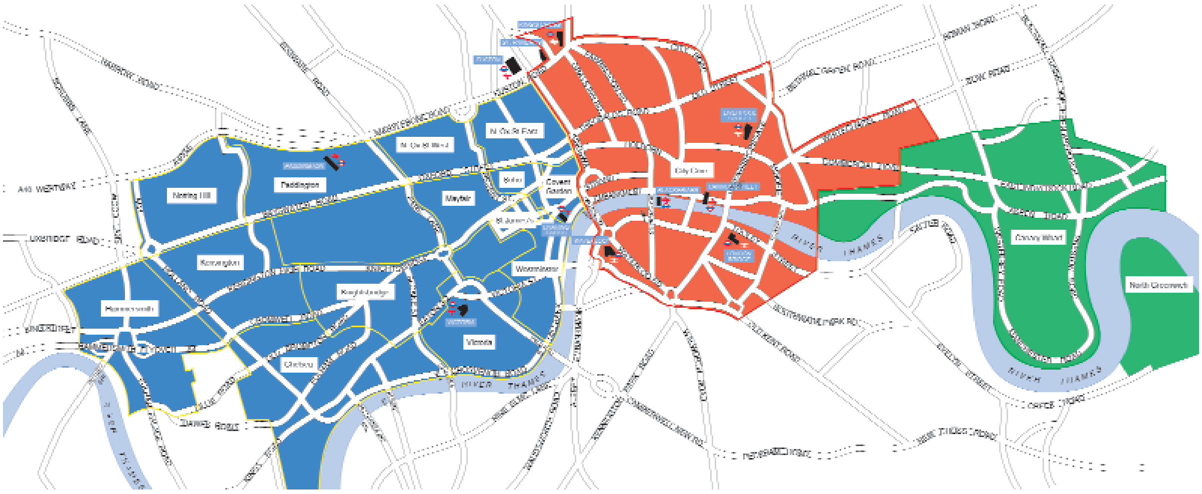
In the City of London the undersupply story is not quite as convincing. There is undoubtedly a shortage of high quality units of 25,000 sq ft or less, and this is where some rental growth is already emerging. In the medium to larger size bands there is less oversupply. 2012 will see the final two investment banking style buildings battle it out in a relatively sparse market. Once one of those two buildings is let then there will be a credible undersupply story at the top end of the City market.

The next five years will definitely not be a boom period in the central London office market, but while the recovery will be slower than we have seen before, it will also last longer. The restrained lending market will hold back the speculative development pipeline and keep supply and demand in balance. 2012/13 will be the years when the supply shortages really start to bite in London, at least on Grade A space. As a result of this we continue to forecast that average prime rental growth will be a steady 5% per annum for 2012-2016.

Prime rental growth will continue



Survey area & key contacts



Monthly market data

We also produce monthly market reports on the City and West End leasing and investment 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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