SUMMARY

- Take-up in all of the three main central London submarkets was above average in the first half of the year.

- The recent trends in the vacancy rate have been more diverse, with availability in the West End continuing to fall, while in the City the vacancy rate has risen due to development and refurbishment completions. Overall, the central London trend is downwards.

- Prime office rents remain on a gentle upward trend, though the rate of growth remains lower than would normally be seen at this stage of the cycle.

- Investment activity in the first half was marginally up on the same period last year. However, we do not expect that 2014’s out turn will reach the record level that was seen last year.

- Looking ahead, while the demand side story remains positive, the volume of development activity has risen significantly. This has caused some of London’s specialist office developers to voice caution about the future. We examine the prospects for demand and supply in this issue’s Outlook.

“Three out of the next four years will see above average levels of development completions”
Mat Oakley, Savills Research
West End leasing

H1 2014 take-up reached two million sq ft, 18% ahead of long-term average levels for the first six months of the year. Unlike 2013, no one large transaction skewed take-up levels, rather it is a pick up in overall occupier activity due to positive news regarding the UK economy. We recorded 188 transactions in the first six months of 2014, compared with 130 over the same period last year.

Who has been driving this demand? The Technology, Media & Telecoms (TMT) sector continues to dominate take-up accounting for 28%. As forecast in our previous report, the Insurance & Financial Services sector has experienced an increase in take-up levels. Over a 10-year period (2004-13) the sector has accounted for, on average 11.5% of annual take-up, in H1 it took a 15% share, its highest proportion since 2007. The latest CBI/PwC Financial Services Survey shows that optimism continues to grow amongst UK Financial Services against a background of improving economic growth, with most sectors planning to increase headcount.

The most significant story of H1 2014 is the low vacancy rate, in May it fell to 3.5% equivalent to 4.2 million sq ft of supply, its lowest level since December 2007. This is also being experienced at a submarket level with all 12 submarkets in the West End currently experiencing less than two years of supply (six of which have less than one years supply).

This has resulted in the pick-up in pre-letting activity, H1 2014 has seen 284,500 sq ft in eight pre-lets, this is already in-line with the 10-year annual average of eight pre-lets per annum. We expect to see a continuation of this trend over the remainder of the year.

Developments

Looking at supply going forward, over the next four years we estimate 2.1 million sq ft completions per annum, slightly ahead of the 1.8 million sq ft historic average. 2016 is set to experience a boom in development activity, 2.8 million sq ft is expected to complete, the highest level since 2004. Furthermore, development activity in six West End submarkets over this period is >20% ahead of average annual submarket completions over the last 10 years (2004-13).

Looking at these figures in more detail, the 2014 development completions have already been included in our supply figures, 45% of which has been pre-let. Over the next three years (2015-17) 10% of pipeline is committed and the same proportion is a significant refurbishment. Discounting this, the development pipeline still looks fairly robust delivering 1.8 million sq ft over the next three years. Refurbishment activity is on the decline (accounting for 16% in 2015, down from 62% in 2012), a sign that the restrictions on development finance have eased considerably.

We do not expect to see any further significant falls in the vacancy rate, this is reinforced by the addition of approximately 720,000 sq ft of 2015 development completions to our supply figures over the remainder of 2014. Significant schemes to be added include; 130,000 sq ft at Blackstone’s Adelphi, 188,000 sq ft at Land Securities Zig Zag and 80,000 sq ft at the Crown & Exemplar’s W5, New Burlington Place scheme.

Requirement levels stand at 2.9 million sq ft; this is in-line with the 12-month average. 27% of requirements are from the Insurance & Financial sector, the largest of which is Jupiter Asset Management’s 60,000 sq ft search, who are rumoured to be under offer at Zig Zag.

Rents

Average prime rents reached £103.33 per sq ft in Q2, up 4% on Q1 and their highest level since Q4 2007. This rental growth has been positive for some landlords in the West End’s core markets however is this the same across all submarkets? In short, yes, average Grade A rents have also reached 2007 levels at £73.00 per sq ft. Conversely, average Grade B rents remain at well below peak levels indicating that tenants remain heavily biased towards the best quality space.

Source: Savills
West End investment

Following the record performance of the West End investment market in 2013, the first half of 2014 has broken yet another record with turnover reaching £3.1 billion, which is the highest level of turnover in the first six months of the year since our records began.

Six transactions over £100 million contributed to this strong performance, the largest of which (in a single transaction) was Perella Weinberg Partners acquisition of 33 Grosvenor Place for £204 million, reflecting 4.61% net initial yield.

Despite this large transaction from a US investor, overseas buyers have not dominated transaction volumes so far this year, unlike 2013. Increasing appetite from UK buyers has led to domestic investors purchasing £1.8 billion of West End assets in H1 2014, accounting for 59% a share. This follows UK buyers re-entering the market last year due to the increased availability of debt and being under pressure to buy, after being relatively quiet throughout the downturn. We also believe that some UK investor interest is being driven by the inability to deploy capital in the UK regions at sensible prices, which has refocused these fund’s attention back on the more liquid growth stock in central London.

European and US investors accounted for 14% each following acquisitions in excess of £100 million by Meyer Bergman and Perella Weinberg Partners. Asian Investors have been notably quiet purchasers this year accounting for just 4% of transaction volumes compared to 22% over the same period last year.

The demand for West End assets has seen capital values surpass their 2007 peak for the first time since the downturn, in June 2014, IPD reported that values were 1.4% ahead of 2007 levels, significantly ahead of the All UK Property and City office capital value levels.

The rationale for selling at present is mixed, though the primary reason appears to be profit-taking on the back of the strong uplift in capital values over the last three years. Indeed, some investors who had bought over this period with the intention of keeping their assets for their long-term income growth potential are also considering bringing them to the market in the final quarter of 2014 or early 2015.

Yields

Savills prime hypothetical West End yield remains at 3.25%, its eighth month at this level. This low yield is supported by further compression of the IPD average equivalent yield to 5.02%, down from 5.21% at the start of the year. Prime yields will remain low so long as investor demand remains at above average levels, rents continue to see upward pressure and base rates do not rise at an unsustainable rate.

Outlook

A return of occupier confidence and signs of real rental growth returning to the occupational market the West End will continue to attract inward investment from domestic and non-domestic investors alike. This and forecasted work based employment growth of 7% in the borough of Westminster over the next five years (2014-18), according to Oxford Economics, cements the position of the West End as a popular destination for security and growth. However, what are the challenges that could derail the West End as a popular place for investment on a world stage?

The upcoming rise in interest rates, could have an impact on borrowing costs. Any initial rise however is likely to be minimal, with interest rates forecast to reach 2% over the next three years, which is relatively low in historic terms. Competition amongst lenders will also minimise this threat, with lenders’ margins being adjusted to keep the overall cost of debt relatively stable. This, combined with the very small proportion of buyers who are actually using debt, should minimise the impact of rising interest rates. However, for multi-asset investors there will come a point where yields on bonds start to look more attractive than prime West End offices especially if rental growth ever hits a plateau.

Even against a background of rising interest rates, and a gentle rise in property yields, we expect to see continuing strong investor demand for both dry West End assets and asset management or redevelopment opportunities.

GRAPH 5
West End investment volume

<table>
<thead>
<tr>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td>£ Million</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1,000</td>
<td>2,000</td>
<td>3,000</td>
<td>4,000</td>
</tr>
<tr>
<td>5,000</td>
<td>6,000</td>
<td>7,000</td>
<td>8,000</td>
</tr>
<tr>
<td>9,000</td>
<td>10,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Savills

GRAPH 6
West End office yields

Source: Savills, Investment Property Databank

savills.co.uk/research 03
City leasing

City take-up for the first half of the year rose for the third consecutive year reaching a total of 3.3 million sq ft (Graph 8), equating to a 15% rise on this point last year. It would seem the strong take-up seen this half is due to the economy continuing to recover and move into growth combined with the increased confidence in the market, built on the success of last year.

The City saw two deals this half that exceeded 100,000 sq ft: ING’s acquisition of 125,000 sq ft at 8 – 10 Moorgate, EC2 on an 18 year lease at £51.50 per sq ft, and Mizuho’s acquisition of 196,000 sq ft at Two New Ludgate, EC4 on a 20 year lease. Last year we witnessed an increase in large deals of this nature, however this year the rise in take-up appears to have come about through a rise in transactions of small to medium sized units. This half we saw a 35% increase in the amount of space acquired in the 10,000 – 15,000 sq ft bracket compared with this point last year.

We are now starting to witness the effects of having more footloose occupiers taking space in the City through the impressive performance of the City fringe this half. The City core saw a 5% increase in take-up in the last 12 months, compared with a 23% increase in the fringe areas. This has been a result of growing sectors such as TMT, who are not tied to a specific location, being attracted by the cheaper rents found in the fringe areas.

Most sectors performed well this half, with the Insurance & Financial Services sector being the most active, accounting for 26% of all take-up. The Professional sector and TMT sector came in second and third at 16% and 13% respectively. Furthermore, it appears the recovering economy has had its effect on the Banking sector with their share of take-up rising from 1% at this point last year to 5% at the end of H1 this year.

This half has seen an increase in demand for the City’s towers. Take-up in the towers has risen by 9% on this point last year reaching 405,000 sq ft, with the Gherkin, the ‘Walkie-Talkie’, Salesforce Tower and Tower 42 now all over 90% let. Moreover, we have seen the average rent paid in the towers increase from £56.18 per sq ft last year to £62.15 per sq ft this year, and the average rent free fall from 30 months to 20 on a 10-year lease. Evidence of rising rents combined with falling incentives is what we would expect to see in a strong performing market in an easing economy as the power shifts in favour of the landlord.

Supply at the end of H1 this year reached 405,000 sq ft (Graph 8), equating to a 15% rise on this point last year reaching 405,000 sq ft, with the Gherkin, the ‘Walkie-Talkie’, Salesforce Tower and Tower 42 now all over 90% let. Moreover, we have seen the average rent paid in the towers increase from £56.18 per sq ft last year to £62.15 per sq ft this year, and the average rent free fall from 30 months to 20 on a 10-year lease. Evidence of rising rents combined with falling incentives is what we would expect to see in a strong performing market in an easing economy as the power shifts in favour of the landlord.

Rents

Rents have generally either remained stable or risen this half. The average Grade A rent has remained stable currently at £47.48 per sq ft, and average prime rent has only fallen slightly from £64.45 per sq ft (at the end of 2013) to £63.70 per sq ft at the end of this half. However, if we compare the average of the top 10 rents achieved in 1H 2013 with that of 2014, we see a 10% rise from £60.70 per sq ft to £67 per sq ft.

We forecast rental growth for average Grade A buildings to rise by 6.5% next year. Moreover, further benefiting the landlords, we predict the average annual rental growth for the average prime rent will be 3.7% pa over the next four years.

Development

As previously stated, the success of the City’s leasing market is dependent on the development pipeline fulfilling the needs of a growing economy with increasing demand for office space. It is encouraging at first to see the amount of space scheduled to arrive over the next four years is above the long term average for each year (except for 2015 which is only slightly below). However, 27% of this space is already pre-let, including half of the space due to arrive next year. Therefore, we predict there will be a tightening of supply over the next 12 months, most likely resulting in a continuation of rental growth.
City investment

It has been an active first half of the year in the City investment market with £4.4 billion already transacted, which is a 19% increase on the same period last year which totalled £3.7 billion. Last year produced a City record in turnover amounting an impressive £12.2 billion. However, even though turnover is up on this point last year, it would be surprising if this figure was beaten again this year, as it was achieved by a massive £6 billion being transacted in the last quarter alone, of which £3.4 billion was from Blackstone acquiring a 50% stake in Broadgate and St Martins acquiring the More London Estate.

The largest deal of the first half of the year was the purchase by China Life of 10 Upper Bank Street, E14 for £795 million, 5.27% yield. Another significantly large deal was the purchase by Tishman Speyer of 33 Canary Wharf for £795 million, 5.27% and £775 per sq ft. The property is let to the market. The building fell into Receivership earlier this year and is now on the market through Savills at a price in excess of £650 million. We expect there to be a considerable amount of demand from all types of investor for this substantial piece of central London real estate.

In contrast to last year, which saw a dominance from non-domestic purchasers within the City, this year we have seen UK investors account for 57% of acquisitions. It appears we are seeing the results of increased pressure placed upon UK purchasers from last year to place equity, brought about through increased competition from private and international investors. Rising net inflows to the property funds are driving a sharp increase in UK institutional activity across the UK, with the comparatively narrow gap between yields in the City of London and those in the prime regional cities driving strong investor interest in this market.

Asian investors were the second most active group of buyers this period, followed by European purchasers in third, at 17% and 11% respectively. Going forward, we see the UK funds continuing to be the main purchasers with North America and Asia predominantly focusing on the larger lot sizes of over £200 million.

Yields

Savills prime City yield remains at 4.5% at the end of the half, this is the fourth month at this level, hardening from 4.75% at the start of the year. This hardening has been supported by rising rents and a low base rate. The primary cause of this appears to be the combination of strong demand with restrained supply of prime stock in the City core. The spread between the City and West End still remains wide but has reduced this half from 150 bps to 125 bps.

The IPD indices are showing a continuing steady hardening in average office yields in the City, with the average initial yield hardening from 4.93% in December 2013 to 4.63% in June 2014. IPD estimate that the average capital value growth on City of London offices over the last 12 months has been 16%, a factor which may cause holders of City office investments to consider profit-taking.

Outlook

The outlook for the City investment market appears to be a positive one as we foresee investors start to continue to widen their focus beyond safe, income protection type assets to more value-add type investments where they can profit from the forecast rental growth. The City occupational market is performing above average and across the next four years we predict prime rental growth to average 3.7% p.a., which will in turn attract investors to the City. For the second half of the year, we expect the dominance from UK purchasers to remain, with a bias towards core plus and value-add investment opportunities, particularly in the City fringe markets where the rental growth prospects look strong. This increased demand for value-add assets in fringe locations will result in a hardening of their yields.

Graph 9

City of London turnover by quarter

Graph 10

City office yields

Source: Savills

savills.co.uk/research
Docklands

The Docklands market is certainly benefitting alongside the City with the improving market conditions as total take-up for the half reached 690,000 sq ft. This is a massive 275% increase on the same period last year and an 8% increase on the total amount of space taken across the whole of last year. The large amount of take-up certainly followed on from the second half of 2013 where 500,000 sq ft was transacted.

The large amount of take-up has been primarily due to the following large deals: EY’s acquisition of 207,000 sq ft at 25 Churchill Place, E14, GDF Suez Energy’s acquisition of 62,000 sq ft at 25 Canada Sq, E14, and EBA’s acquisition of 58,000 sq ft with HS2’s acquisition of 55,000 sq ft both at 1 Canada Square, E14.

Total availability at the end of the first half of this year stood at 1.3 million sq ft for the entire Docklands area. Total availability for the Docklands core is currently at 882,000 sq ft, giving a vacancy rate of 5.5%. Currently, it is 5 Churchill Place, E14 that has the most amount of available space at 320,000 sq ft with a quoting rent of mid to late £30’s per sq ft. This building has actually been shortlisted by Societe Generale as a potential place for a new headquarters.

The largest asset currently on the market in the Docklands, and indeed the whole of Central London is the HSBC Tower, E14 in Canary Wharf for £1.1 billion, 4.86% and £1,007 per sq ft.

As previously predicted, the Docklands market is becoming increasingly more attractive to occupiers who are more footloose or looking to capitalise on the lower rents. For instance, the Ministry of Justice took 33,000 sq ft at 11 Westferry, E14 for £30 per sq ft, and Interoute Communications, a technology firm, took 30,000 sq ft at 25 Canada Sq, E14 for £35 per sq ft. This is roughly £15 cheaper per sq ft than in the City for accommodation of a similar specification.

Rents

The rents in the Docklands may be cheaper than the City at the moment, but this market is also starting to experience upward rental growth. The average rent for the first half of this year was £35.92 per sq ft, a 15% increase on the average rent at the end of 1H 2013 (£31.22 per sq ft), and a 7% rise on the average rent across the whole of 2013. Furthermore, this half saw the highest rent achieved in the Docklands since 2007 at 25 Churchill Place, E14 by EY when they committed to a rent of £48.50 per sq ft.

We foresee the average rent for a single Tower floor in the Docklands to rise to £45 per sq ft by 2017.

Outlook

Overall, the outlook for the Docklands is a positive one with increased take-up, rents and demand all forecasted for the next 12 months. The market provides occupiers from all different sectors with a cheaper alternative to the more traditional City core. However, this market may also become increasingly threatened by the emerging market at Stratford City. We have already seen TfL pull out of a deal at 10 Upper Bank Street, E14 for another building in Stratford City due to failing to achieve board approval for the Docklands.

The gap between City of London office rents and those in the Docklands remains wider than normal, and we expect this gap to close gradually over the next five years.
**Outlook**

At the beginning of 2014 we commented that the medium term prospects for the market would depend heavily on the speed at which the speculative development market reactivated. This is clearly a concern at the forefront of most developer's minds, and the first half of 2014 has seen the majority of the London specialists stating that they felt that their forward pipeline was full enough for the present. In this issues’ Outlook section we delve deeper into the forward looking demand and supply situation, and examine whether the top of the current cycle is likely to be in three to four years’ time as some commentators are suggesting.

As we have alluded to earlier in this report, the supply-side is certainly reacting to the pick-up in demand and falling levels of vacancy. While the early years of the recovery were characterised by a sharp pick-up in refurbishment activity, the pipeline is now filling up with new-build and redevelopment projects. Indeed, three out of the next four years will see an above average level of development completions across the City and West End, though 19% of this 21 million sq ft is already pre-let (well above normal levels of pre-letting for the central London market as a whole).

The bulk (70%) of this development activity is taking place in the City office market, rather than the very undersupplied West End. Is this a case of right space in the wrong place, or if you build it will they come?

When you look at recent leasing market trends, as well as the tone of current requirements, it is clear that something fundamental has happened to the central London office market over the last five or six years. More than one million square feet of businesses have moved from the West End eastwards over the last 18 months, driven by low vacancies in the West End, more new build space in the City, and perhaps the recognition that for staff attraction and retention central London is becoming increasingly homogenous.

A decade ago our requirements spreadsheets used to be dominated by tenants who were highly specific on what part of central London they wished to be in. Now, the majority of requirements are for central London as a whole, with the top three motivators being public transport accessibility, property cost, and quality of supporting retail and leisure infrastructure. The evolution of the City and Canary Wharf’s supporting infrastructure has now meant that for many workers and employers a move to either location is no longer seen as a bad one.

So, is this just a short term blip or a long-term trend? We believe that it is the latter, and the old boundaries between the City and West End, and possibly the City and the Docklands, will become increasingly blurred over the next 10 years. This blurring will undoubtedly be aided by the completion of Crossrail. What this will mean for the market is that a high vacancy rate in one area will not necessarily be a bad thing, as it will enable tenants to move to that location from other more expensive sub-markets. Thus, the fact that the City is facing a development bulge is probably of less concern than it might have been in previous cycles. No longer is the current level of availability in the City market having to be absorbed by the local market, with an average annual take-up of around 4.5 million sq ft per annum.

Going forward we need to think of the availability and development activity in one particular submarket as a resource for the whole of the central London office market, with an annual average take-up rate of around 10 million square feet. Against that background, the current vacancy and planned development pipeline start to look much more in balance with demand. Indeed, with an estimated one to two million square feet per annum of office stock being converted to other uses, this level of development activity may not even be enough to satisfy a phase of the cycle when London’s businesses are in growth mode.

Are London’s specialist office developers wrong to be cautious about the medium-term supply and demand balance? Definitely not, but this doesn’t mean that there is an impending development-driven oversupply. We expect that leasing activity will average around 10.5 million sq ft per annum over the next three to four years, and this combined with change of use will be enough to keep the central London vacancy rate on a very gentle downward trend. However, it wouldn’t take much of a surge in debt availability and speculative development to reverse this picture, and that will undoubtedly be the harbinger of the next downturn in central London office rents.

That having been said, we remain optimistic about the short to medium term prospects for the market. We expect rental growth to be slightly lower than average for this stage of the cycle, primarily due to the flat trajectory that we are predicting for vacancy rates. However, London still offers good prospects for income growth driven investors.
Survey Area

Monthly market data

We also produce monthly reports on the City and West End leasing and investment markets that include key statistics and comparables on each of these markets. If you would like to be added to the mailing lists for these, or any other research reports, then please e-mail your request to moakley@savills.com

Savills Central London Offices

Please contact us for further information

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

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

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

Felix Rabeneck
Investment
(0)20 7409 8918
frabeneck@savills.com

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

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

Kuldeep Lalli
Research
(0)20 7016 3833
klalli@savills.com

Ben Raywood
Research
(0)20 7499 8791
braywood@savills.com

Savills plc
Savills is a leading global real estate service provider listed on the London Stock Exchange. The company established in 1855, has a rich heritage with unrivalled growth. It is a company that leads rather than follows, and now has over 500 offices and associates throughout the Americas, Europe, Asia Pacific, Africa and the Middle East.

This report is for general informative purposes only. It may not be published, reproduced or quoted in part or in whole, nor may it be used as a basis for any contract, prospectus, agreement or other document without prior consent. Whilst every effort has been made to ensure its accuracy, Savills accepts no liability whatsoever for any direct or consequential loss arising from its use. The content is strictly copyright and reproduction of the whole or part of it in any form is prohibited without written permission from Savills Research.