Central London investment activity set to increase in 2020

The impact of clarity

Central London leasing office market appeared completely unaffected throughout the Brexit negotiation period of 2016 – 2018, however the investment market saw a 34% decrease in turnover last year in comparison with 2018. The two failed attempts at leaving the EU during 2019 cast doubt in the minds of some foreign investors on the merit of buying and vendors responded by adopting a wait and see policy, causing a significant lack of supply.

The leasing market continued to perform above expectation, experiencing sustained tenant demand which in turn led to an increase in pre-letting activity. Furthermore, the Serviced Office Provider sector continued to grow and saw the arrival of new entrants such as Convene and Knotel, who are not showing any signs of slowing down in the short-medium term.

The macro outlook for the UK is positive when compared with our European counterparts with a forecasted 1.4% GDP growth per annum for the next five years, which is in-line with France and 20bps higher than Germany. This will help position the UK as a desirable destination for any European bound foreign capital and with Greater London expecting 2.4% GDP growth per annum for the next five years, it is likely the majority of foreign capital headed for the UK will be deployed in the capital.

Investment turnover in central London during 2019 reached £13.3 BN, 34% down on 2018 but only 18% down on the 10-year average. The two Brexit dates that came, passed with little alleviation of uncertainty, however the drop in turnover appears to be a global trend as opposed to exclusively a local one. For instance, Hong Kong saw a fall of 69% Y-O-Y, Central Paris 11% down, Frankfurt 42% down and Chicago 53% down. However, politics definitely did play a part in the London office market as once the Conservative party had gained a majority we saw a noticeable increase in investor activity. In fact, 20% of City investment and 30% of West End investment turnover from 2019 took place in December.

There was a distinct lack of stock available for purchase last year, which inevitably affected turnover volumes. However, the lack of clarity certainly affected foreign investor’s confidence as non-domestic turnover fell from a 73% share in 2018 to 65% last year. Despite this, UK investors

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Chart 1: GDP growth forecasts

- **2020**: 1.4% pa
- **2021**: 1.4% pa
- **2022**: 1.2% pa

- **United States**: 2020-2024 % pa
- **Canada**: 1.4% pa
- **Japan**: 1.4% pa
- **United Kingdom**: 1.2% pa
- **France**: 1.4% pa
- **Germany**: 1.4% pa
- **Italy**: 1.2% pa
- **Brazil**: 1.4% pa
- **Russia**: 1.2% pa
- **India**: 1.4% pa
- **China**: 1.2% pa

Source: Focus Economics
Now that we have clarity regarding both Brexit and the general election, demand from foreign capital will increase, which when combined with the current lack of stock, will result in a hardening of prime yields throughout 2020.

Central London now looks comparatively high yielding to the rest of Europe.

Chart 2: Central London turnover by nationality

Chart 3: European net prime yields

Looking forward, London still looks comparatively high yielding to the rest of Europe where Paris, Amsterdam, Frankfurt, Berlin and Munich all stand at 3.00% or below. However, this only benefits those that are prepared to bear the currency risk, which otherwise might cost the equivalent to 100 bps. It is worth noting that the rental growth prospects for London are stronger than the majority of Europe and therefore the increase in demand that this could bring, will almost certainly result in further hardening of London prime office yields throughout 2020.
Occupational market

Serviced Office Providers continued their expansion into London last year, ensuring take-up finished above average.

The London occupational market continued to outperform expectations last year. Given the consistent few years of above average take-up, Brexit uncertainty and the anticipated slowdown from Serviced Office Providers, it seemed likely that take-up would finish under the 10-year average in 2019. However, the market seemed almost unaffected by Brexit and we didn’t see any large financial institutions leave the capital. Furthermore, Serviced Office Providers continued to grow and acquire more space, which resulted in 11.1m sq ft being transacted across both the City and the West End markets. This was down on 2018 by just 13%, but remained up on the 10-year annual average by 7% and the eighth largest year on record.

At the end of 2019, we saw 6.7m sq ft of take-up in the City, which was down on 2018 by 13%, but up on the 10-year annual average by 5%. This shows the strength and resilience of the City leasing market during a year which had two Brexit block dates and a general election. The City core accounted for the majority of take-up with a 58% share during 2019. The preference for grade A space has remained representing 81% of total take-up.

At the end of Q4, the majority of demand in 2019 actually came from Serviced Office Providers, having accounted for 23% of take-up or 1.5m sq ft across 44 deals. This is up on the whole of 2018 by 10 deals and 68% in terms of quantum of space. WeWork has been responsible for 15 of these deals alone equating to 439,693 sq ft (39% of total Serviced Office take-up), while Knotel have continued their rapid expansion from the US into London having acquired 9 new centres equating to 223,112 sq ft (15% of total Serviced Office take-up). Demand from Insurance & Financial services remained strong and accounted for 20% of take-up to the end of Q4. 87% of this space has been acquired in the core. The Tech & Media sector have increased their leasing activity since the start of 2019 and represented 20% of total take-up. There has also been continued stable demand from the Professional services sector who accounted for 12%.

Take-up also remained robust in the West End with 4.5m sq ft completing across 377 transactions during 2019. This is down on 2018 by 14% in terms of quantum of space, but up on the 10-year annual average by 12%. In total, whilst the Tech & Media sector continued to account for the largest proportion of take-up (25%), space let to Insurance & Financial sector occupiers reached a near record level of 910,000 sq ft. This is the second highest take-up to this sector on record, only narrowly overtaken by 2007’s 920,000 sq ft. Over the past three years we have seen year on year increases to the overall space acquired

<table>
<thead>
<tr>
<th>Year</th>
<th>Serviced Office Provider Take-up</th>
<th>Traditional Occupier Take-up</th>
<th>Serviced Office Provider Take-up as a % of total take-up</th>
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<td>16,500,000 sq ft</td>
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Source: Savills Research
Supply remains constrained with vacancy rates low in a historic context

by Insurance & Financial sector occupiers. In total the sector accounted for 22% of annual take-up, which is the highest proportion of annual West End take-up this sector has ever accounted for. Mindspace’s acquisition of 34,500 sq ft at the Metro Building, W6 in December, saw the total amount acquired by the Serviced Office Provider sector reach just shy of 700,000 sq ft for the year, which accounts for 17% of take-up. This is down 29% on the long-term average and is in contrast with the City, which saw serviced offices acquire more space than any other occupier type.

As a result of the strong and diverse levels of demand seen over the last two years, the Central London vacancy rate has remained low in an historic context, sitting at 4.8% at the end of Q4 2019 compared to the 10-year average of 5.7%. Furthermore, if we assume that no more supply is added to the market, at the current rate of take-up, there is only approximately 13 months’ worth of supply remaining in both the City and the West End markets.

However, while the City vacancy rate is currently 5.5% and the West End at 4.4%, we believe these figures may be misleading due to the significant quantum of take-up by Serviced Office providers that have subsequently re-launched the same space back onto the market. A more accurate analysis taking into account the occupancy of serviced office centres alongside Savills Workthere team suggests 100bps could be added to each of our respective City and West End vacancy rates.

Looking forward, we expect take-up to remain slightly above the long-term average in both markets during 2020 as occupiers benefit from improved clarity from Brexit and improved political stability. We anticipate pre-letting activity to remain high as occupiers commit their long-term futures to London.

Furthermore, Oxford Economics are forecasting Greater London office based employment to grow by 1.6% during 2020, even allowing for Brexit related job relocations. However, any decrease in Banking and Financial jobs is expected to be more than offset by increases in employment in the Information & Communication sector and the Professional, Scientific and Technology sectors.

For instance, Facebook who are already in 230,000 sq ft in 1 Rathbone Place, W1 and 90,000 sq ft in 10 Brock Street, NW1, made the decision in 2018 to pre-let 615,000 sq ft across three buildings in King’s Cross, and expanded within 10 Brock Street, NW1 in 2019 by the further acquisition of 144,000 sq ft.

Chart 5: Central London supply and vacancy rate

50% of the number of all leases signed last year were for 10 years or more

Average rent free remained stable at 20 months in the West End and 23 months in the City on a 10-year lease
Development

The development pipeline for Central London offers very limited prospect of relieving the constraint on supply.

Looking at forecast supply over the next four years, there is 27m sq ft of extensive refurbishments and new developments scheduled for completion across Central London.

It is worth noting that figures for both 2023 and 2024 may both change with developer’s enthusiasm for delivery tempered by both planning and construction delays.

Over the past five years we have seen sustained levels of strong occupier demand which has resulted in high levels of pre-lets. Pre-lets have accounted for a quarter of the overall space that was acquired. Any prospect of the development pipeline relieving Central London’s constrained supply diminishes when you factor in almost a quarter of the space scheduled for delivery over the next four years has already been pre-let.

An additional 5% of the remaining speculative available space is under offer with larger occupiers increasingly forced to launch their searches up to 5 years in advance of delivery to secure their preferred space. Due to the prevalence of pre-lets, around 50% of the 7m sq ft expected for completion during 2020 has already been pre-let.

Continued strong demand against the backdrop of limited supply is particularly challenging for larger occupiers in the West End, where larger floor-plates are even rarer.

Currently there are only around 25 Grade A floors available in the West End which could satisfy a single floor requirement sized 15,000 sq ft and over. Less than 5 of these floors are located in Core West End sub-markets (St James’s, Mayfair, Soho, North of Oxford Street & Covent Garden), where the Grade A vacancy rate currently stands at 2.3%.

Looking forward, supply is set to remain constrained across the Core West End sub-markets, with the entire amount of speculative space scheduled for delivery over the next five years amounting to just 4.2m sq ft in total. This is the equivalent of 14 months’ worth of Grade A take-up at the rate we have experienced over the last 5 years. As a result, we expect more West End occupiers seeking to expand or relocate, being forced to consider fringe and City alternatives.

The City market accounts for 70% of development activity over next five years with peak levels of completions expected for this year and into 2023. High levels of development activity this year are partly due to the scheduled completion of 22 Bishopsgate, EC2 (1.3m sq ft). 2023 activity is boosted by 40 Leadenhall, EC3 (878,449 sq ft) and 1-5 Paris Gardens, SE1 (607,000 sq ft).

Almost 30% of speculative space scheduled for the next five years is located in the City Core. This is in comparison to the entire speculative pipeline across all West End sub-markets which accounts for 35%.

Chart 6: Central London development pipeline

Source: Savills Research. These are all forecasts to the best of our current knowledge and are likely to change.
However despite the high levels of development activity we are set to see in the City over 2022 and 2023, when the entire speculative pipeline for the City for the next 5 years is also compared to the average rate of demand we have seen over the past five years, it only equates to just over 2 years’ worth of Grade A take-up.

Development activity is also set to peak across the SE1 sub-market over 2023 with 1.9m sq ft set to be delivered. Notable schemes which are set to complete in addition to 1-5 Paris Gardens include 25 Lavington Street (370,000 sq ft) and The Stamford, 18 Blackfriars Road SE1 (269,385 sq ft). Whilst only 7% of the development pipeline for SE1 has currently been pre-let, we expect low supply in the West End will stimulate further pre-lets across this sub-market.

We expect to see more pre-lets from the Insurance & Financial sector over the next few years with the sector accounting for over a quarter of occupiers with upcoming lease events in the West End.

Chart 7: 2020-2024 Speculative pipeline by sub-market

![Chart](chart7.png)

Source: Savills Research

Chart 8: Forecast speculative development for the next four years vs 5-year average grade A annual take-up

![Chart](chart8.png)

Source: Savills Research
Occupiers focus

Central London occupiers have become increasingly more footloose and building specific with their searches for new space

Top 5 considerations behind significant 2019 transactions

1. Landlord credibility
2. Limited choice & supply
3. Quality of building
4. Sub-market location
5. Size/efficiency of floor-plate

Over recent years we have seen Central London occupiers become more footloose and the nature of tenant searches become increasingly product-led rather than locationally driven.

As a result of this change in focus we have seen strong demand for high quality, well designed buildings, even attracting tenants to areas they traditionally wouldn’t be associated with. For example, the Brunel Building in Paddington has achieved much success and unprecedented rents for that sub-market from occupiers more commonly associated with West End core markets.

Around 45% of the current 11.7m sq ft of active and potential tenant requirements we are currently tracking are Central London wide. This is in contrast with five years earlier where Central London wide requirements only made up 17%, with the majority of searches being specifically focused on either the West End or the City.

Occupiers currently located in the West End account for almost three quarters of potential and active Central London requirements, with limited supply forcing occupiers located here to broaden their search criteria to include the City. This is in contrast with City specific requirements, which are essentially all from occupiers already located there.

The increased awareness of the lack of supply across Central London is also having an impact on the type of considerations that are being made by occupiers on whether to remain at their existing location or relocate. Over the past two years, we have seen supply constraints become a strong rationale for many occupiers choosing to renew or extend at their existing space.

It has also had an impact on the increased importance occupiers attach to landlord credibility as a result of the increased prevalence of pre-lets and the importance of schemes being delivered on time.

Whilst searches have become more building specific, sub-market location still remains an important factor, particularly for occupiers in the Insurance & Financial sector in the City, who have a strong preference for being close to sector clusters, primarily seen in EC3. White City is another example of this and it’s ability to attract life science occupiers like Novartis, Autolus and Synthace, and ultimately creating a sector cluster that is continuing to attract further demand from other life science occupiers.

Locations with a good public realm offering, strong transport links or future infrastructure improvements, coupled with newly developed stock will attract strong demand, such as Farringdon, Clerkenwell & Victoria.

Occupiers are showing an increase in demand for larger and more efficient floor-plates, which are currently sparse in the West End, and therefore are considering City locations due to the increased availability. Moreover, the opportunity to capitalise on lower occupational costs will also drive more price sensitive/footloose occupiers to migrate eastwards.

Chasing the product

We are seeing more occupiers changing sub-markets than ever before

We have analysed our leasing data over the past five years looking at office take-up over 20,000 sq ft in the City and 15,000 sq ft in the West End, where the tenant has simply relocated from one office building to another (as opposed to acquiring an additional office), excluding serviced office deals.

Since 2014, 60% of occupiers have changed their immediate location either through a change of submarket or primary postcode, reflecting the increasingly footloose nature of Central London occupiers.

What has been notable is the number of occupiers who have relocated from the West End to the City. Whilst in total only 57 occupiers previously located in the West End (out of 191), have relocated or expanded into the City market, the total quantum of space they have acquired equates to 3.2m sq ft. This accounts for over a third (35%) of space that was acquired by tenants previously located in the West End.

In contrast only 11 occupiers migrated from the City back to the West End which equates to 514,000 sq ft, 4% of the overall space acquired by tenants previously located in the City).

Over 70% of occupiers who moved from the West End to the City acquired space on larger floor-plates with more than half of these occupiers (57%) acquiring space on floor-plates sized between 15,000 - 55,000 sq ft.

We expect to see more West End occupiers migrate east into the City and fringe locations due to greater choice and larger floor-plates being available. Occupiers generally prefer large floorplates to allow increased staff collaboration and efficiency of occupation.

In the City during 2019 we saw more occupiers relocating to a different sub-market within the City than over the five years prior. EC2 was equally popular for attracting tenants already situated in this sub-market as well as attracting tenants from other parts of the City.

The largest example being Ashurst, relocating from Broadwalk House, EC2 to take the whole of London Fruit & Wool Exchange, E1 (275,536 sq ft). They then sublet 115,680 sq ft of this space to NEX, who moved into the area from 1-2 Broadgate Circle, EC2.

E1, EC1, EC3 and EC4 saw more tenants relocating from other sub-markets over this period. In EC1, the largest example of this occupier migration has been DLA Piper who took 146,482 sq ft in 160 Aldersgate, EC1, migrating from 3 Noble Street, EC2.

7 out of the 11 occupiers who acquired space over this period in WC1 (Midtown) were West End occupiers previously located in sub-markets bordering this sub-market (Covent Garden, NOX East).

Over 2019 we also saw an increase of West End occupiers changing sub-markets than over the previous five years. The Victoria sub-market was particularly popular with occupiers and saw good tenant retention, accounting for almost half of the West End tenants remaining in the same sub-market. It also experienced a high influx of tenants from other locations including Oaktree Capital, Cheniere Marketing and Neuberger Berman.

Figure 1: West End occupier migration since 2014

Source: Savills Research
Rental Forecasts

Low vacancy rates and a constrained pipeline will result in rental growth across London over the next five years

The strong performance of the leasing market for both the City and the West End, combined with the low levels of available supply and constrained pipeline have resulted in strong rental growth forecasts across the whole of central London for the next five years. For clarity, our average prime rents are calculated using actual transactional evidence and are the average of the top 10% of the known rents within the time period.

Furthermore, these forecasts are all assuming that we are able to successfully transition out of the EU by the end of 2020 on favourable terms that still allow us access to the European financial markets. If this transition period takes significantly longer than anticipated or we fail to agree access to the financial markets through the method of ‘equivalency’ then we can expect to see the rental growth prospects hindered, albeit the quantum is difficult to accurately forecast.

Looking at the West End, the average prime rent for Q4 last year settled at £114.00/sq ft, up on Q4 2018 by 10.3%. Although we are not expecting there to be falls in either grade for the next five years, we are forecasting average annual growth of 2.5% for West End prime rents over the next five years, and 2.0% per annum for average grade A rents. This will result in the average prime rent reaching £129.25/sq ft and the average grade A rent reaching £79.00/sq ft by Q4 2024.

In the City, the average prime rent for Q4 last year settled at £78.03/sq ft, up on Q4 2018 by 4.7%. Due to the constrained current level of supply and future pipeline along with the increased likelihood of West End occupiers migrating over to the City, we are forecasting average prime rents in the City to grow by an average of 3.5% per annum for the next five years, 100 bps higher than the West End. We are also forecasting average grade A rents in the City to grow by 2.9% per annum for the next five years. This will result in the average prime rent for the City reaching £92.50/sq ft and the average grade A rent reaching £73.75/sq ft by the end of 2024.

We are also expecting the City Core and the City Fringe West to grow at a rate of 3.5% per annum for prime rents for the same reasons but also due to the high levels of demand from the Insurance & Financial sector and the Technology sector for office space in these locations, who typically can afford to pay the higher rents.

We are expecting locations that are currently starved of supply and that will benefit from the arrival of Crossrail and innovative new buildings to grow at the fastest rate. Hence the West End North (NOX East & West, King’s Cross & Euston, and Paddington) is forecasted to grow at the fastest rate of 4.5% per annum for prime rents for the next five years due to the arrival of Crossrail which will directly benefit this submarket and a number of new schemes planned that could achieve high rents.

Chart 9: 2020 Q4 - 2024 Q4 Rental forecasts by submarket

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<th>Submarket</th>
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Source: Savills Research
Savills Commercial Research
We provide bespoke services for landowners, developers, occupiers and investors across the lifecycle of residential, commercial or mixed-use projects. We add value by providing our clients with research-backed advice and consultancy through our market-leading global research team.