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Savills World Research
UK Commercial

Review and Outlook
Central London office

September 2017

Photo source: iStock

SUMMARY

■ Demand in both the West End and City has defied expectations so far in 2017, with take-up in excess of average in both markets at the half way mark. In contrast, take-up has been subdued in the Docklands.

■ Availability has remained constant in the City and Docklands, while we have witnessed only a slight increase in the West End.

■ Headline rents have held in the West End while we have seen only a slight decline in the City. Both markets have witnessed an increase in the level of incentives being granted to tenants.

■ Boosted by an influx of foreign capital, investment volumes in both the City and West End are significantly above the long term average with high levels of demand, particularly for large "trophy" assets.

■ Looking ahead, the fundamentals of the Central London office market remain strong. In both the City and West End the amount of supply under offer and active market requirements are above average which suggests a strong H2 can be expected. Similarly, recent high levels of pre-letting in both markets have resulted in speculative development completions being kept to a moderate level, resulting in only a gentle increase of vacancy rates being expected over the short-medium term.

"The strong performance in the first half of the year highlights the Central London office market's resilience and its continued attraction to occupiers and investors across the globe"

Ben Raywood Savills Research

H1 Take-up is 30% above the 10-year average

Vacancy rate is 4.1%, below long-term average of 4.6%

Average of 2.1m sq ft of completions per year to 2020 vs. historic average of 1.8m sq ft

H1 2017 average prime rent of £118.25/sq ft is 7% up on 2016

West End leasing

H1 2017 take-up reached 2.35m sq ft across 226 transactions, the third highest H1 total on record and 30% above the 10 year H1 average.

Who has been driving this demand? Serviced Office Providers continue to be increasingly active in the West End and were the most active sector in H1 accounting for 27% of take-up, with WeWork accounting for 74% of this sector's activity. With several providers actively pursuing expansion opportunities and new entrants to the market such as Uncommon and Storey, we expect the sector to remain highly active in H2. Whilst the Tech & Media sector may have been displaced from the top spot, the sector continues to be highly active accounting for 25% of take-up.

Moving into H2, 1.3m sq ft of supply is currently under-offer (98% above the long term average) and we are currently tracking 5.2m sq ft of active requirements (19% above the long term average). As such, take-up looks on course to exceed the 3.9m sq ft recorded in 2016.

The West End has witnessed a gradual increase in availability in 2017, with supply at the end of H1 standing at 4.97m sq ft, equating to a vacancy rate of 4.1%. This is 20bps above the vacancy rate of 3.9% at the end of 2016, however 50bps below the long-term average of 4.6%. Looking forward, with just 370,000 sq ft of speculative completions scheduled in the first half of 2018 and 1.3m sq ft of supply currently under offer, we are likely to see a gradual reduction in availability in the remainder of 2017.

Developments

There is set to be an average of 2.1m sq ft of completions per year in the West End between 2017-2020, which is slightly ahead of the 1.8m sq ft historic average.

However, due to the constriction on supply in the West End, pre-letting has become increasingly prevalent as tenants have been forced to act early in order to secure suitable office space, particularly for larger requirements. Indeed, 34% (1.34m sq ft) of 2016's and 31% (0.74m sq ft) of H1 2017's take-up was space pre-let before completion, while 29% of the 2017-2020 pipeline has been pre-let. This trend is likely to continue, reducing the amount of speculative space being delivered to the West End market, preventing any potential over supply. Indeed, removing pre-let schemes there is set to be an average of 1.5m sq ft of speculative completions per year between 2017-2020.

Rents

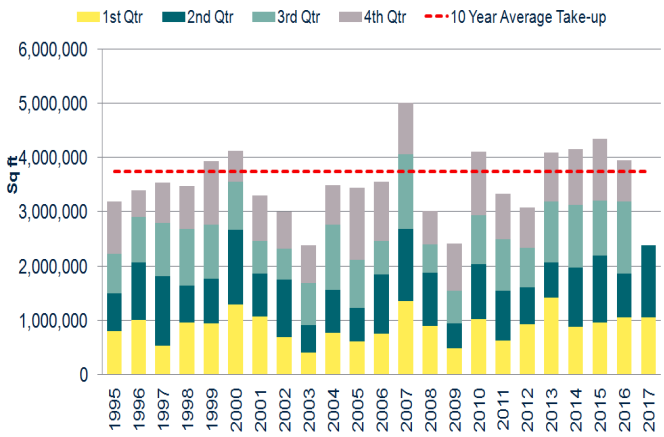
The West End has continued to see strong headline rental levels in 2017. There have been 27 transactions with rents above £100.00/sq ft in H1 2017 compared to 33 across 2016. These are led by a record rent of £190.00/sq ft achieved at 5 St James's Square. Boosted by these transactions, the average prime rent at the end of Q2 2017 was £118.25/sq ft, 7% above £110.50/sq ft recorded in 2016. Similarly, the average Grade A rent has risen by 8% on last year, standing at £83.22/sq ft at the end of Q2 2017.

Whilst headline rents have held strong, the current uncertain economic climate has placed upward pressure on the level of incentives being offered to tenants. The average rent free period on straight 10 year leases in 2017 is 20 months, compared with 16 months in 2016.

Clearly there is a limit to the amount of tenant incentives landlords can offer and it is likely that we may see downward pressure on headline rents in H2 2017 and 2018, particularly in the prime end of the market. In line with future take-up levels, the extent to which headline rents fall may be dictated by the outcome of Britain's Brexit negotiations with the EU and the impact this has on the ability of businesses to operate in Britain and the EU. However, the West End's broad tenant base, low vacancy rate and limited speculative development pipeline should prevent any drastic drops in rental levels.

GRAPH 1

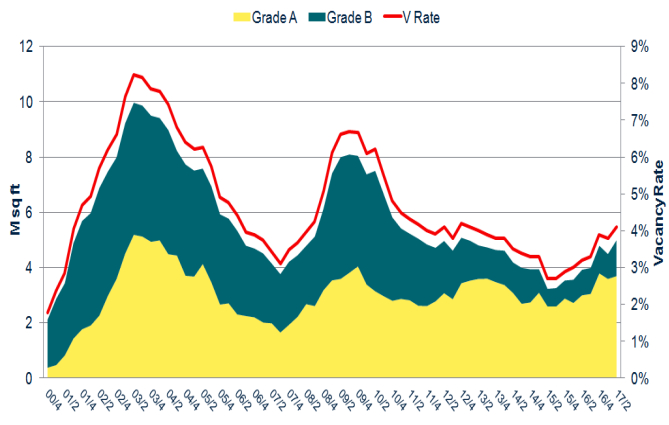
West End take-up by quarter



Graph source: Savills

GRAPH 2

West End supply and vacancy rate



Graph source: Savills

H1 turnover of £3.96bn is the second highest ever recorded

Total of 55 transactions, which is lowest number of H1 deals on record

Average prime yield of 3.25%, is down on this point last year where it stood at 3.50%

International investors continue to dominate turnover, accounting for 73%

West End investment

The West End has continued to witness high levels of investment in 2017, with turnover at the end of H1 standing at £3.90bn, just shy of the record £3.96bn recorded in H1 2015. Interestingly, whilst investment volumes in H1 2017 were the second highest ever recorded, this was spread across just 55 transactions which is the lowest number of H1 deals on record.

Turnover has remained buoyant, despite the low number of transactions. This is a result of investors targeting both scale and high quality assets, which in the main are 'well let' and in good physical condition. There has been a record six transactions over £200m up to the end of June, the same amount recorded in all of 2016. Indeed, deals of £200m or greater have totalled £1.64bn making up an unprecedented 42% of total volume compared to just 18% in 2016. This resulted in a record average deal size in H1 of £73m compared to £46m in 2016.

In terms of the sources of demand, international investors continue to dominate, accounting for 73% of investment volumes. Asian investors have been particularly active in the first half of the year making up 38% of total volumes, while European investors have accounted for 27%. UK investors are still active; albeit in the main for smaller assets. Whilst investors from the UK transacted on 24 properties, the average deal size was £44m compared to £134m to Asian investors. We have seen little activity from Middle Eastern and US investors so far this year with purchasers from these regions accounting for just 5% and 1% of turnover respectively.

Unsurprisingly, strong overseas demand has resulted in the sales market being dominated by domestic sellers (80%) with UK institutions alone accounting for over a quarter of all sales. This has been a continuing trend over the last 3 years with the total net disinvestment from this category of investor in excess of £4bn since 2015. We expect the continuation of this theme as long as current market conditions prevail.

Yields

In the immediate aftermath of the EU referendum we moved the Savills prime hypothetical yield out 25bps to 3.50%. However, strong investor demand led us to move the yield back down to 3.25% in November 2016 and it remains at this level at the end of H1 2017. This low yield is supported by further compression of the IPD average equivalent yield to 4.70%, down from 4.78% at the beginning of the year.

Outlook

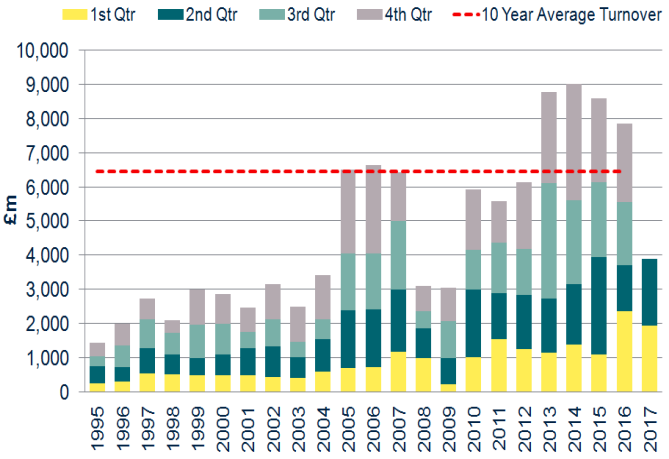
We believe we are set to witness a continuation of current market conditions in the second half of 2017, with strong buyer demand. International investors will remain dominant as they continue to be drawn to the market by the discount offered by the depreciation of sterling and the secure income that Central London property can provide.

Well let 'trophy' assets will continue to have particularly high levels of demand and ensure the average deal size remains at a record level. The continuation of this trend is placing further downward pressure on prime yields which could lead to further hardening in H2. The leasing market's current resilience and diversity will also ensure West End property remains attractive to investors.

Investment volumes at the end of H1 are well on course to exceed the 10 year annual average of £6.4bn. Looking to the second half of the year, with demand levels persisting and many large sales pending, we expect to see similar investment volumes in H2 2017.

GRAPH 3

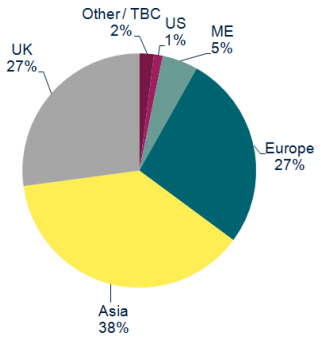
West End turnover by quarter



Graph source: Savills

GRAPH 4

West End turnover by nationality and avg deal size



Region	Avg Lot Size (£million)
UK	£45.1 M
Euro	£95.1 M
US	£23.6 M
ME	£41.7 M
Asia	£133.4 M
Other	£78.0 M
ALL	£73.3 M

Graph source: Savills

H1 Take-up is 20% above the 10-year average

Vacancy rate is 5.6%, below long-term average of 6.6%

Average of 3.7m sq ft of completions per year between 2017-2020, up on historic average of 3.1m sq ft

H1 2017 average prime rent of £74.50/sq ft is 4% down on 2016

City leasing

H1 2017 take-up reached 3.2m sq ft, of which 80% was of a grade A standard. This is 19% up on this point last year, and 20% above the 10-year H1 average.

Traditionally, the Insurance & Financial services sector has accounted for the majority of take-up in the City, although this appears to be changing, with these sectors only accounting for 13% of take-up so far this year. The highest demand has come from the Tech & Media sector who have accounted for 24% of take-up. Significant deals from Framestore at 28 Chancery Lane (94,000 sq ft) and ITV at 2 Waterhouse Square (89,000 sq ft) have contributed to the lion's share. There has been consistent activity from the Professional services sector which has accounted for 16% of take-up, although this has been considerably aided by Freshfields Bruckhaus Deringer LLP acquiring 288,000 sq ft at 100 Bishopsgate. Serviced Office Providers have continued to acquire space in the City this year, accounting for 8% of take-up, with WeWork sourcing a new centre at Mark Square House, EC2 (70,000 sq ft).

At the end of Q2, there was 1.8m sq ft under-offer which is up on the long-term average by 39%, giving a good indication that we will see the high level of take-up continue for the remainder of the year. Especially, as we are now aware that circa 564,000 sq ft of the 1.8m sq ft under-offer has since completed in one deal which saw Deutsche Bank commit to a new HQ at 21 Moorfields.

Due to an active first half of above average take-up, we did not see an increase in the vacancy rate at the end of Q2. There is currently 6.9m sq ft of available supply, equating to a vacancy rate of 5.6%, which is up on this point last year by just 40bps, and 100bps below the 10-year average.

Looking forward, with 1.5m sq ft of speculative completions scheduled to arrive in the first half of 2018, we would anticipate the vacancy rate to gently rise over the next 12 months.

Development

From 2017 there are currently only two years of above average completions expected to arrive within the City, with the greatest amount anticipated for 2018 at a total of 5.8m sq ft of which 3.1m sq ft is already pre-let. In fact, 31% of the 10.6m sq ft expected to arrive between 2018 – 2020 is already pre-let, a trend which we expect to continue as larger occupiers are forced to look into the future to guarantee their property requirements are successfully satisfied.

Rents

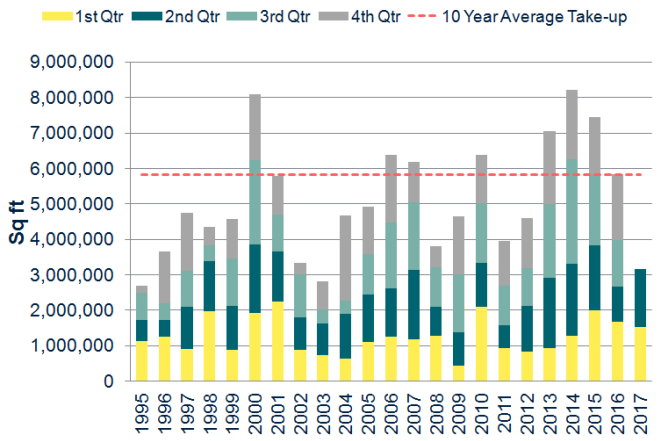
At the end of H1, the average prime rent in the City is £74.50/sq ft, which is down on 2016 by 4%, but up on the 10-year average by 22%. Similarly, the average grade A rent slightly dipped in H1 at £59.75/sq ft, falling by 3% on 2016, however it is still up on the 10-year average by 22%.

Furthermore, we have also seen the gap between the average grade A rent in the City Fringe and the City Core narrow. In 2012, the difference between the two sub-markets was £9.98/sq ft, and this has narrowed to just £0.35/sq ft at the end of H1 2017. Current City Core average grade A rent is £60.24/sq ft while the City Fringe is £59.89/sq ft. This has been a result of new grade A developments in the fringe locations, coupled with more "footloose" occupiers being present in the market who now see these fringe locations as suitable and attractive destinations.

We have also witnessed an increase in the level of incentives being offered in the City. The average rent free period on a straight 10 year lease in 2017 is 22 months, compared with 17 months in 2016. Historically, we have found once incentives reach approximately 24 months rent free, headline rents will begin to fall.

GRAPH 5

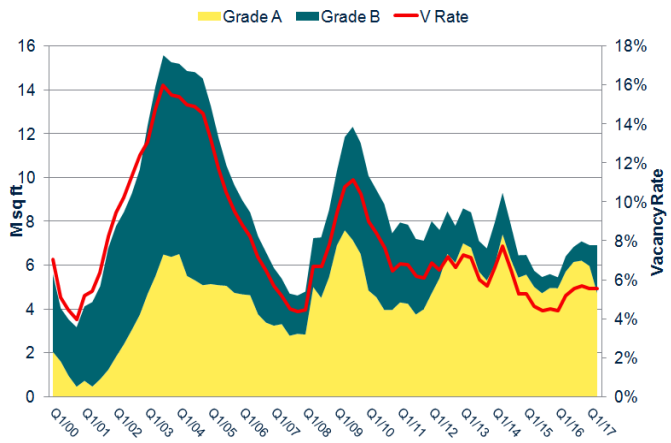
City take-up by quarter



Graph source: Savills

GRAPH 6

City supply and vacancy rate



Graph source: Savills

H1 turnover of £4.98bn is 30% up on the 10 year average

Total of 64 transactions, down on last year by 21

Average prime yield of 4.00%, is down on this point last year where it stood at 4.25%

International investors continue to dominate turnover, accounting for 84%

City investment

The City has seen above average levels of investment so far this year, with turnover reaching £4.98bn in the first half, which is up on this point last year by 17% and 30% up on the 10-year average for H1.

There has been a trend for larger 'trophy' assets as even though turnover is up on this point last year, there has only been 64 transactions in H1 compared with 85 over the same period last year. This is further evident by the ten largest deals so far this year totalling £3.4bn, compared with the ten largest across the whole of 2016 totalling £3.1bn. With more trophy assets expected to be traded in the second half of the year, it is almost certain this gap will widen and therefore likely total turnover will surpass that of 2016.

Similar to the West End, international investors have accounted for the majority of investment this year accounting for 84% of turnover. Asian investors have continued to be a prominent source of this foreign investment, as they accounted for 50% of total City turnover for H1. The continued weakness of Sterling, combined with the activity of new entrants and their desire to diversify out of their domestic market, has resulted in Asian investors flooding Central London. European purchasers have also been attracted to City properties as they accounted for 25% of turnover in H1. German funds have been responsible for almost the entirety of the mainland European investment, attracted by high quality real estate and attractive risk adjusted returns on a pan European basis. Investors from the UK have accounted for 28 of the 64 transactions, however they have only accounted for 16% of turnover, showing their appetite has been for the smaller lot sizes. As with the West End, activity from the US and the Middle East remains relatively muted as they both have only accounted for 4% of total turnover.

Yields

Following the referendum, we saw yields in the City move out 25bps as they reached 4.25% at this point last year. However, that has been the ceiling for City so far in this cycle as in February of this year we saw them harden back to 4.00% following the steady stream of foreign investment paying sub 4.00% for some trophy assets.

Outlook

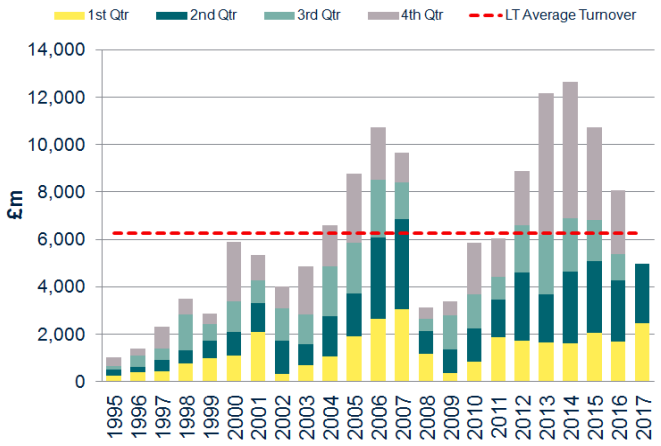
Currently there is strong demand from overseas investors for good quality City assets. In particular, we have seen a great deal of focus on some high profile trophy asset purchases, such as the Leadenhall Building and 20 Fenchurch Street, at historically low yields. Away from those headline grabbing deals we have experienced a consistent level of demand for more generic stock although the pricing and yields have been more consistent with the past 18 months pricing levels.

There has been significant activity from overseas, and in particular from Asian investors, and undoubtedly the recent announcement of further restrictions being imposed on the outflow of capital from China will have a knock-on effect on some of this appetite. This may well have an impact on pricing for some assets, however there is also a healthy level of interest from other international buyers, most notably form Europe and the Middle East , which will continue to create competition for this Asian capital.

Unless we see a market deterioration in the leasing market and real rental falls, we expect international investors to continue to find City office investments attractive.

GRAPH 7

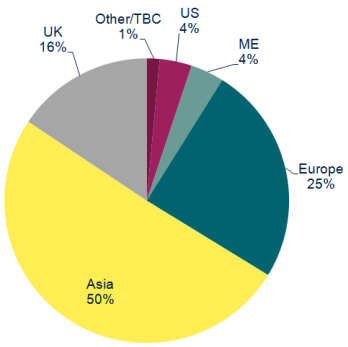
City turnover by quarter



Graph source: Savills

GRAPH 8

City turnover by nationality and avg deal size



Region	Avg Lot Size (£million)
UK	£27.6
Asia	£147.4
US	£60.3
Europe	£205.0
ME	£37.6
Other/TBC	£24.1
All	£79.0

Graph source: Savills

H1 Take-up is 85% below the 10-year average

Vacancy rate is 4.7%, below long-term average of 6.4%

Benchmark rent remains stable on last year at £47.50/sq ft

Rent free periods also remain stable, currently at 27 months for a 10 year term

Docklands

Take-up in the Docklands area has exceeded the 10-year average for the previous three consecutive years, with total take-up reaching 1.3m sq ft in 2016, the highest amount since 2010. The most notable lettings over this period include Societe Generale's pre-let of 280,000 sq ft at One Bank Street, EY's acquisition of 207,000 sq ft at 25 Churchill Place, Deutsche Bank's sub-letting of 388,889 at 10 Upper Bank Street, Thomson Reuters acquisition of 315,000 sq ft at 5 Canada Square and the GPU's acquisition of 536,175 sq ft at 10 South Colonnade. Following this period of high take-up, it seemed inevitable that take-up this year would be muted, especially due to the uncertainty surrounding Brexit, and how the implications of this will affect the Docklands largest occupier type.

The first half of 2017 has been exceptionally quiet in comparison to previous years, with total take-up for the first 6 months at 60,225 sq ft across 9 transactions. This is the lowest half year take-up since H1 2009, when 39,080 sq ft was leased across just 3 transactions, and is in stark contrast to the 10 year average of 478,300 sq ft. The largest transaction in the year to date was Deliveroo's acquisition of 15,000 sq ft at 1 Clove Crescent, which is on the periphery of the core estate.

Historically, the Docklands market has been home to the world's banking and financial services sector. Although, we have seen a recent desire from the core Canary Wharf estate to amend this image through the introduction of Level 39, a technology centred co-working space. Level 39, which has grown from a simple idea into a three-floor, 80,000 sq ft community space in One Canada Square, seeks to bring together some of the world's fastest growing tech companies.

Total supply in the Docklands has come under downward pressure since the start of 2013, where there was 1.7m sq ft of available supply. This is largely due to above average levels of take-up for the previous three years. Currently, there is just 1.01m sq ft of available supply in the Docklands market, equating to a vacancy rate of 4.7%. This is extremely constrained given the 10-year average is 6.4%. The largest quantum of space available within the core Canary Wharf estate can be found at 5 Churchill Place (181,332 sq ft).

Rents

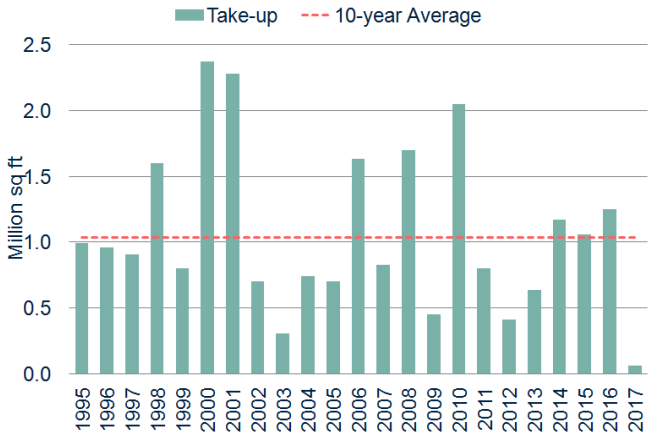
The fact that rental levels in the Docklands are lower than other Central London markets can help in attracting potential occupiers who can't afford the high rents in the core West End or City markets. We are of the opinion that the current benchmark rent has stabilised over the last 12 months, in line with the wider Central London market, and remains at £47.50/sq ft. For part floor lettings we have also maintained our benchmark rent of £50.00/sq ft. Rent free periods might begin to move out over the next 6 to 12 months (depending on the path of the vacancy rate), but currently we have maintained a 27 month incentive for a 10 year lease term for a whole floor. For longer lease lengths, we have also continued to adopt 36 months for a 15 year term and 37 to 42 months for a 20+ year term certain.

Outlook

Looking forward, the Docklands and primarily the core Canary Wharf estate is probably the most affected submarket in Central London by the UK's decision to exit the EU. It is still too early to predict with any certainty as to what will occur in rental terms, as there are a number of variables to consider (e.g. movement of employees to mainland Europe, the potential for investment banks and hedge funds to have access to the European financial market, the outcome of general negotiations with the EU, the amount of "grey" space that will come to the market and expansion space required by the legal sector). However, we expect the opening of the Elizabeth line, scheduled for December 2018, to begin to have a positive impact on the location where we expect rents to rise in the medium term. Nevertheless, in line with the City office market, it appears reasonable to anticipate that rents could be fairly flat over the next 3 years, but it will require continued review during the UK's exit negotiation period to March 2019.

GRAPH 9

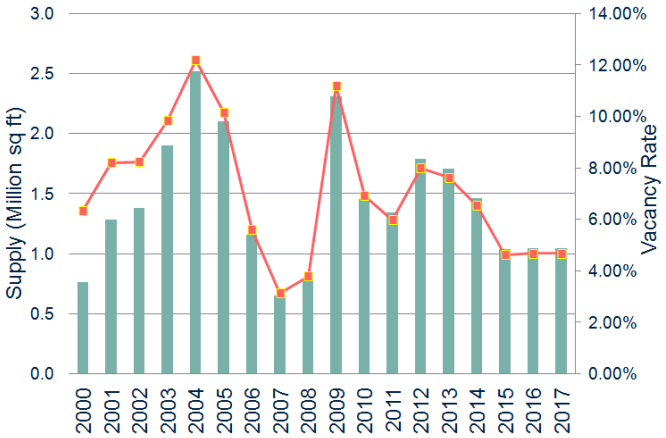
Docklands take-up



Graph source: Savills

GRAPH 10

Docklands supply and vacancy rate



Graph source: Savills

Outlook

The fundamentals of the Central London office market remain strong. Following three years of above average demand, we were always forecasting take-up to return to more normal levels in 2016 and the EU referendum decision only served to reaffirm this. However, take-up defied expectations in both the West End and City in the second half of 2016 and has continued to do so in 2017. Similarly, availability remains considerably below the long-term average. We are also yet to witness any significant decline in headline rental levels, although there has been a reduction in net-effective rents as incentives have increased.

Market indicators suggest a strong second half of 2017. Under-offers and active requirements are significantly above the long-term average, while the high level of pre-letting has minimised near-term speculative deliveries meaning vacancy rates should remain relatively stable.

Looking beyond 2017, the performance of the Central London office market is highly dependant on the terms Britain agrees when leaving the EU and the impact this has on the ability of businesses to operate in Britain and the EU.

As has been much publicised, the banking sector will be the hardest hit by Brexit and banks are beginning to finalise plans to move some functions to the EU. However, banks will clearly need to retain a significant presence in the global financial centre that is London. Deutsche Bank's recent pre-let of circa 564,000 sq ft at 21 Moorfields, EC2 on a 25 year lease provides a clear example of this.

While we are likely to witness a reduction in the Banking sector's London footprint, the Tech & Media sector continues to drive take-up across Central London. This is certainly not a new trend in the West End, however, it was encouraging to see the sector was the most active business sector in the City in the first half of 2017. Since the Brexit referendum vote there are numerous examples of some of Tech & Media's leading firms reaffirming their commitment to the capital. These include Apple pre-letting 500,000 sq ft at Battersea, Google pressing ahead with the construction of its 800,000 sq ft European headquarters at King's Cross and Amazon exercising their option to acquire an additional 175,000 sq ft at Principal Place, taking their occupation to 630,000 sq ft in this location.

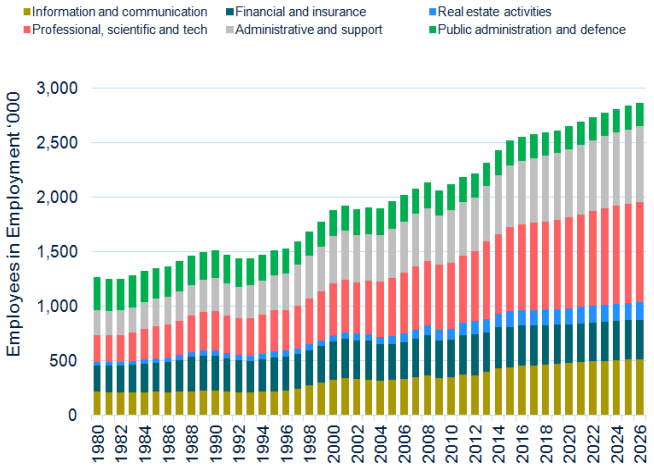
The greatest risk to future take-up levels is any restrictions imposed on immigration which could potentially restrict London's labour pool, resulting in skill shortages that could lead to businesses locating elsewhere. However, Amber Rudd's recent statement that "The UK must remain a hub for international talent. We must keep attracting the brightest and the best migrants from around the world." suggests the government will seek to address this issue. Furthermore, Oxford Economics forecasts Greater London's office based employment to consistently grow over the next nine years which bodes well for future take-up levels.

A sharp recovery in the value of the pound appears unlikely in the near future. This should ensure that London property continues to look comparatively cheap to many non-domestic investors and as such we expect international investors to continue to dominate and investment volumes to remain at above average levels. There will continue to be particularly high levels of demand for high quality space and income.

With the current dominance on international investors, a clear risk to the market would be any shock that causes a reduction in their demand. However, we understand several UK private property companies and REITs who are now highly liquid following their recent sales, are waiting for value opportunities to present themselves. As such, if any shock were to occur that dampened international demand causing a softening in yields, we would expect the domestic institutions to re-enter the market.

GRAPH 11

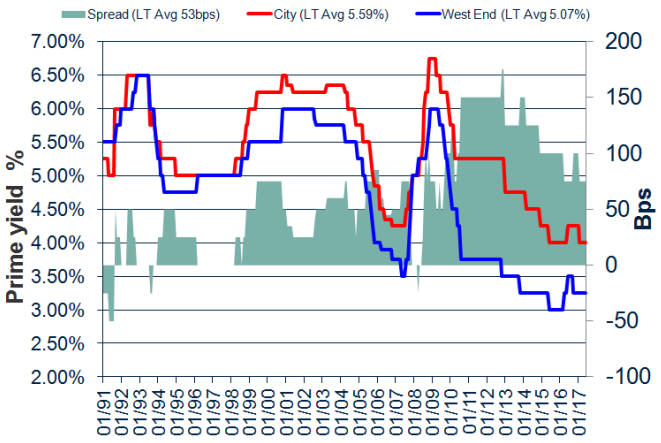
Greater London office based employment



Graph source: Oxford Economics

GRAPH 12

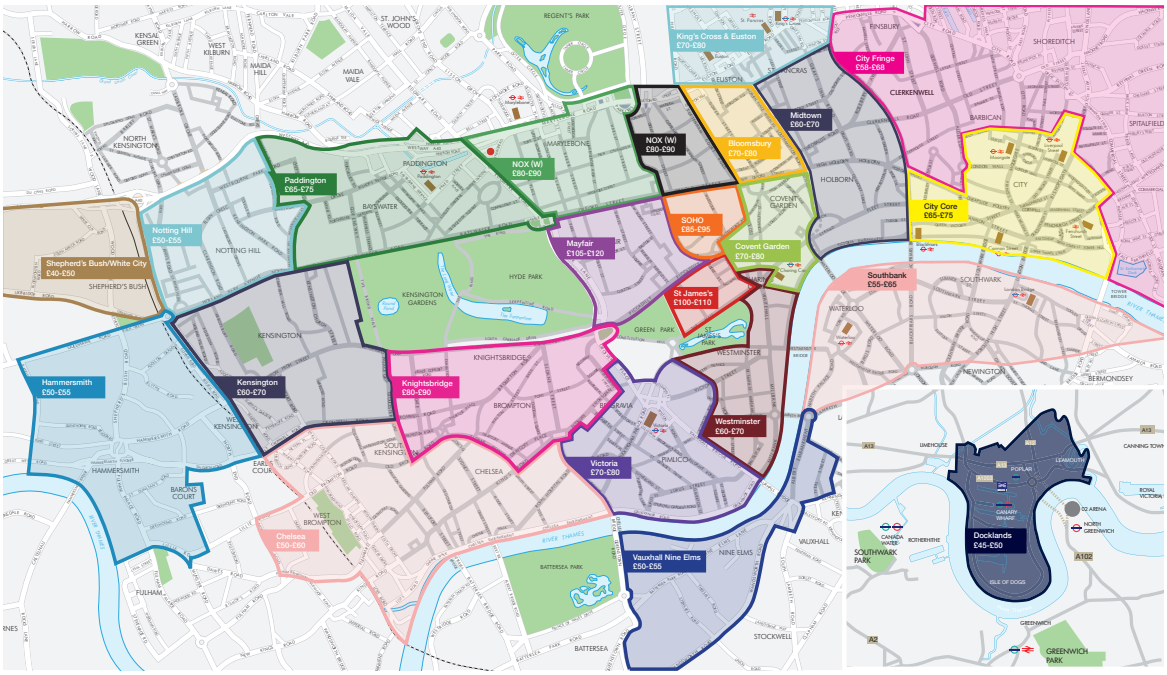
Central London prime yields



Graph source: Savills

Survey Area

Central London Rental Tone map Q3 2017



*Rental tones based on typical 5,000 - 10,000 sq ft floor, Grade A, non tower, no terrace.

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
Head of Central London & International Investment
020 7409 8001
sdown@savills.com

Philip Pearce
City Leasing
020 7409 8917
ppearce@savills.com

Hunter Booth
West End Leasing
020 7409 8832
hunter.booth@savills.com

Felix Rabeneck
City Investment
020 7409 8918
frabeneck@savills.com

Paul Cockburn
West End Investment
020 7409 8788
pcockburn@savills.com

Mat Oakley
Head of Research
020 7409 8781
moakley@savills.com

Ben Raywood
City Research
020 7409 8791
braywood@savills.com

David Garland
West End Research
020 7016 3832
dgarland@savills.com

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