# Savills Global Tenant Rep Guide:
# **Prime Office Space** Q3 2016

savills Studley

The Savills Global Tenant Rep Guide for Prime Office Space presents a quarterly snapshot of total occupancy costs for Class A office space in strategic global markets.

## A focus on: London

### Idea in brief

#### The problem

Quantifying Brexit occupancy cost impact for US companies with UK subsidiaries can be straight forward if one assumes no relocation outside of London. Understanding how to capitalize on current market uncertainty is unclear.

#### The solution

Opportunistically evaluate landlord net effective and prime office cap rate spreads.

#### The outlook

"Mark to market" resistance by London landlords will increasingly come under pressure during the next 6 months as newly delivered space is stress tested.

## Hong Kong replaces London as most expensive Global City

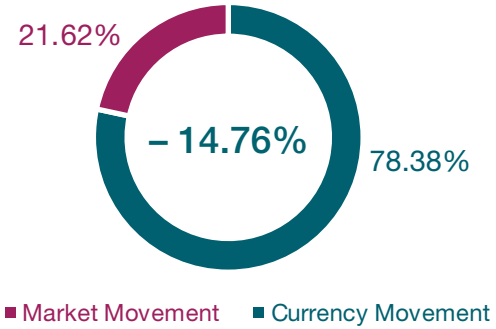
Since June, Hong Kong surpassed London as the most expensive global city for prime office space. A modest increase in Hong Kong occupancy costs, coupled with a dramatic decline in the value of sterling delivered a reduced occupant expense of 11-12% for UK subsidiaries of US parent companies reporting in USD. A slowdown in transaction velocity and volume for prime West End properties with quoted headline rents >100 GBP has driven an additional 4% reduction in headline rents, and an 8.8% increase in abated rent offered. Overall, this results in a net reduction in total occupancy costs of 3.6% to the UK subsidiary when measured in local GBP currency or circa 15% in USD.

**$259.53**
Total Occupancy Cost
22 June 2016

**$221.23**
Total Occupancy Cost
29 September 2016

**– 14.76%**
Overall Change

**OCCUPANCY COST**
Change In Detail




*Since September 29th, sterling has fallen further against the dollar to 1.22 as the UK Prime Minister outlined a fixed timetable to triggering Article 50 by end March 2017.

## Landlords stand "relatively" firm while uncertainty spreads widen

Well capitalized London prime office landlords are still empowered with stabilized assets and majority control of the inventory. In addition, a significant drop in the 10 year gilt since June kept post-Brexit cap rates relatively stable for prime office assets (approx. 3.5% for West End). The widening of prime office cap rate spreads above the 10 year gilt is the result of a significant increase in overall market uncertainty since June. (see chart A)

Prime spreads have risen by almost 150 basis points since Q1 2016. Only twice over the last 17 years have spreads been over 200 basis points (December of 2008 – Global Great Recession and August of 2012 – Eurozone Debt Crisis) as seen in chart B.

Chart A

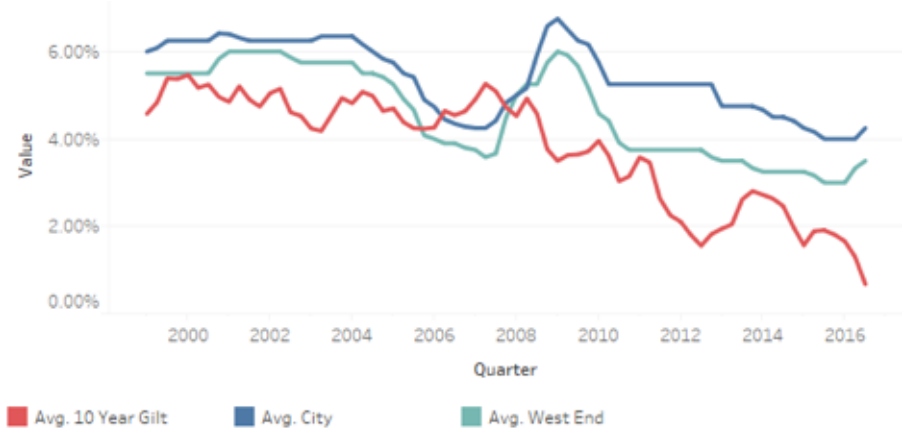
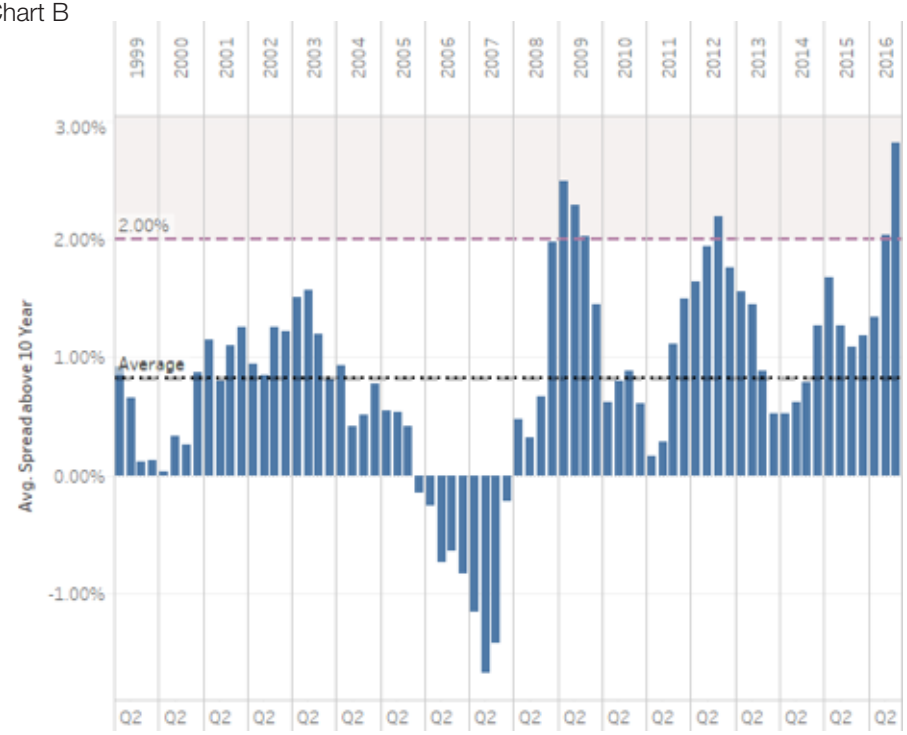



Chart B




## What next?

Optimists present the following case: i) London shall remain the region's center of commerce, ii) rents will continue to trend upward due to low vacancy, iii) 10 year gilts will remain at historic low rates, and iv) prime yield spreads should revert to historical average (approx. 82bps), thereby actually increasing values for investors that can see through the temporary fog of uncertainty hanging over London.

If optimists are correct, there would be no incentive to acknowledge the significant expansion in underwritten net effective rent spreads, as seen in table A.

Table A

| | June 22nd, 2016 | September 29th, 2016 |
|---|---|---|
| Headline Rent | GBP 125.00 | GBP 120.00 |
| S/L Void Expense | (GBP 8.00) | (GBP 12.56) |
| S/L Concessions | (GBP 1.56) | (GBP 1.70) |
| Net Effective Rents | GBP 115.44 | GBP 105.74 |
| **Spread b/w June 1st Headline Rent and Net Effective** | **-7.65%** | **-15.41%** |

To calculate the impact of "void costs" on the property value, landlords typically debit a pro-forma of the fully leased rent of the property with a combination of i) an absence of rent for the non-leased premises, ii) required pro-rata payment to maintain and operate the building, and iii) pro-rata rate payments for real estate taxes. The magnitude of the "void costs" is driven primarily by the "void period" or the duration during which the premises are not leased to a paying occupier. The above assumes vacancy of 10% of the overall building area.

The primary driver for the change in net effective rent spreads has been an expansion of estimated void cost duration (up by 50%). This change in estimated time to lease vacant space is a result of a i) slowdown in market absorption despite being ahead of the 10 year average, ii) sharp reduction (36% below 10 year average) in "space under offer", and iii) reduced number of tenants in the market (28% reduction by square footage YOY).

Realists will recognize that a higher than average construction rate in 2016 (57% above the 10 year norm) has been underwritten using pre-Brexit assumptions, which has pushed availability upwards in the core West End market, e.g. circa 10% vacancy in St James's.

As these assets deliver (65% of the space remains available), base stock increases and owners find themselves competing for increasingly nervous tenants. If owners re-price to match supply and demand, tenants with upcoming lease expiries who stay in London will be drawn to relocate into newer buildings (all other factors being equal).

A "flight to quality" scenario would place pressure on older buildings to follow suit and offer discounts to offset the cost of continually expanding void cost assumptions.

We expect a more realistic outcome to prevail over the next few quarters as the market recalibrates in favour of the occupier.

## Methodology

This report presents a quarterly snapshot of total occupancy costs for Class A office space in key strategic global markets as provided by Savills' best-in-class local tenant rep brokers.

The adjusted annual gross occupancy quote represents real-time transaction terms ("comps") for 20,000 sq ft (2,000 sq m) of usable space with prime views in a top quality asset with i) a stable capital stack, ii) institutional quality ownership, and iii) a quality location in the prime business district for each city featured. All costs are reported in an annual, standardized format of USD per sq ft of usable space to "level set" variations in currency, reflect local payment protocols, and adjust for measurement practices across the globe.

We have also factored in the credit value to the tenant generated from abated rent for each market and the cost associated with fitting out the premises in order to provide an "all in" total occupancy cost in USD per usable square foot.

The fit out costs were gathered from Savills project managers assuming the same leasing scenario described above plus the following: i) 30% private offices with the remainder of space open plan / communal, ii) construction and cabling only (no furniture or professional fees).

| Rank | Position Change | % Change | Market | Headline Occupancy Costs (Rent+Maintenance+ Taxes) USD / USF | Credit Value of Abated Rent USD / USF | Amortised Cap Ex by Tenant (Per USF per annum of lease term) USD / USF | Total Occupancy Cost (Per USF per annum of lease term) USD / USF | Standard Lease Term (excluding termination / renewal options) | Abated Rent per year of Lease Term (months) | Local Efficiency Factor | Tenant Rep Fee Structure Direct: Paid direct by tenant Lease: Financed through lease by tenant |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | ↑ 1 | 2.53% | Hong Kong | $240.80 | ($11.94) | $23.89 | **$252.74** | 6.0 | 0.67 | 1.11 | **Lease:** New **Direct:** Renewal |
| 2 | ↓ 1 | -14.76% | London (West End) | $230.75 | ($22.10) | $12.58 | **$221.23** | 10.0 | 1.70 | 1.00 | **Direct:** New & Renewal |
| 3 | → | -2.46% | Tokyo | $155.80 | ($8.90) | $55.64 | **$202.55** | 5.0 | 0.80 | 1.11 | **Direct:** New & Renewal |
| 4 | → | -0.55% | Singapore | $107.01 | ($4.87) | $32.47 | **$134.60** | 4.0 | 0.63 | 1.18 | **Lease:** New **Direct:** Renewal |
| 5 | → | -0.07% | Shanghai | $106.24 | ($8.17) | $31.83 | **$129.90** | 3.0 | 1.00 | 1.43 | **Lease:** New **Direct:** Renewal |
| 6 | → | 0.47% | Paris | $122.75 | ($17.98) | $18.51 | **$123.28** | 6.0 | 2.00 | 1.33 | **Direct:** New & Renewal |
| 7 | → | 0.14% | Seoul | $93.80 | ($16.86) | $40.87 | **$117.82** | 5.0 | 3.00 | 2.00 | **Direct:** New & Renewal |
| 8 | → | 0.00% | New York (Midtown) | $109.59 | ($9.13) | $10.27 | **$110.73** | 10 | 1.00 | 1.37 | **Lease:** New & Renewal |
| 9 | → | 7.34% | San Francisco | $100.00 | ($3.33) | $10.63 | **$107.29** | 10.0 | 0.40 | 1.25 | **Lease:** New & Renewal |
| 10 | → | 2.79% | Mumbai | $83.08 | ($1.44) | $18.59 | **$100.23** | 9.0 | 0.22 | 1.54 | **Direct:** New & Renewal |
| 11 | → | 0.00% | Washington DC | $93.26 | ($7.77) | $7.87 | **$93.35** | 10.0 | 1.00 | 1.12 | **Lease:** New & Renewal |
| 12 | → | -0.80% | Dublin | $80.15 | ($3.36) | $8.97 | **$85.76** | 10.0 | 0.60 | 1.00 | **Direct:** New & Renewal |
| 13 | → | 0.07% | Frankfurt | $66.16 | ($5.66) | $15.93 | **$76.43** | 5.0 | 1.20 | 1.18 | **Lease:** New & Renewal |
| 14 | ↑ 1 | 1.85% | Chicago | $66.27 | ($5.52) | $5.42 | **$66.16** | 10.0 | 1.00 | 1.20 | **Lease:** New & Renewal |
| 15 | ↑ 1 | 0.49% | Amsterdam | $53.95 | ($5.47) | $12.50 | **$60.98** | 5.0 | 1.80 | 1.00 | **Direct:** New & Renewal |
| 16 | ↓ 2 | -10.37% | Mexico City | $44.59 | ($1.94) | $15.65 | **$58.30** | 5.0 | 0.60 | 1.05 | **Lease:** New & Renewal |
| 17 | ↑ 1 | -1.13% | Los Angeles (Downtown) | $54.22 | ($4.52) | $3.01 | **$52.71** | 10.0 | 1.00 | 1.20 | **Lease:** New & Renewal |
| 18 | ↓ 1 | -5.48% | Houston | $50.00 | ($4.17) | $5.11 | **$50.95** | 10.0 | 1.00 | 1.14 | **Lease:** New & Renewal |
| 19 | → | -3.63% | Brussels | $45.73 | ($4.36) | $8.17 | **$49.53** | 9.0 | 1.50 | 1.18 | **Direct:** New & Renewal |
| 20 | → | -2.95% | Toronto | $46.45 | ($1.94) | $3.87 | **$48.39** | 10.0 | 0.50 | 1.14 | **Lease:** New & Renewal |

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