GERALDEVE

LONDON MARKETS

London office property performance and key themes

February 2022

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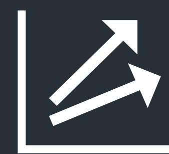
LONDON OFFICE MARKET SUMMARY Q4 2021

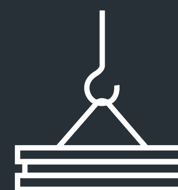
Occupier take-up increased for the fourth consecutive quarter in Q4. Overall, there was just under 3.2m sq ft of leasing activity, driven by several large commitments in the City. This was the highest quarter of occupier activity since before the pandemic and on par with the pre-Covid 5-year average.

With ESG high on occupiers' agendas, pre-lets in the over 50k bracket were focused on buildings set to achieve BREEAM Excellent or Outstanding ratings. There was also evidence of occupiers consolidating employees from multiple offices into one in Q4 which could become more commonplace as companies look to implement hybrid working policies and incentivise staff with more collaborative work environments.



Overall central London availability decreased from 9.4% to 8.7% in Q4, the first sign of overall supply tightening since the pandemic began. Improved letting activity in the second half of 2021 ensured that many submarkets now sit below the recent peaks in availability reached during the pandemic. However, supply in Canary Wharf remains stubbornly elevated at 14.6%.

Prime rents were stable in Q4, with no movement across any tracked submarkets. However, the improving occupier sentiment in submarkets such as Mayfair & St James's and Marylebone, suggested that incentives tightened for the first time since the pandemic began. The lower bound for incentives shifted in by three months, and now stands at 21-24 months' rent free on a 10-year term for both submarkets.



Complications in global supply chains for construction materials as well as general inflationary pressures and labour shortages meant multiple schemes which were set for delivery in Q4 2021 were pushed out to 2022. The overall pipeline for 2022 now totals 8m sq ft, although there's the potential for some of this space to slip as supply chains remain stretched.

Investment activity in Q4 was hampered by Omicron-related restrictions and the total volume was just over £2.5bn, a fall of 25% on Q3 and 18% below the 5-year quarterly average. UK based investors were the most active in London offices, accounting for £1bn of acquisitions, with a respective 90/10 split between property companies and institutions.

3.2m sq ft ▲
Take-up, Q4 2021

8.7% ▼
Availability rate, Q4 2021

3.4m sq ft ▼
Annual completions, 2021

£2.5bn ▼
Investment volume, Q4 2021

THE LONDON ECONOMY

LONDON AND THE REST OF UK GVA

	2020	2021	2022
London	-9.0%	6.0%	5.7%
UK excl. London	-9.3%	7.8%	5.7%

ILO UNEMPLOYMENT RATE

	2020	2021	2022
London	5.7%	6.4%	5.7%

WORKPLACE-BASED EMPLOYMENT GROWTH

	2020	2021	2022
Office	-0.9%	0.6%	1.6%
Non-office	-0.7%	0.4%	2.2%

Source: Oxford Economics

LONDON FLASH INDICATORS PMI DECEMBER 2021

57.5

Business Activity Index

Down from 64.1 in November, indicating a deceleration in growth in December.

57.0

New Business Index

Concerns about the Omicron variant led to cancelled orders and a fall in tourism activity.

75.2

Future Activity Index

Confidence is high for a projected upturn in activity in 2022.

57.9

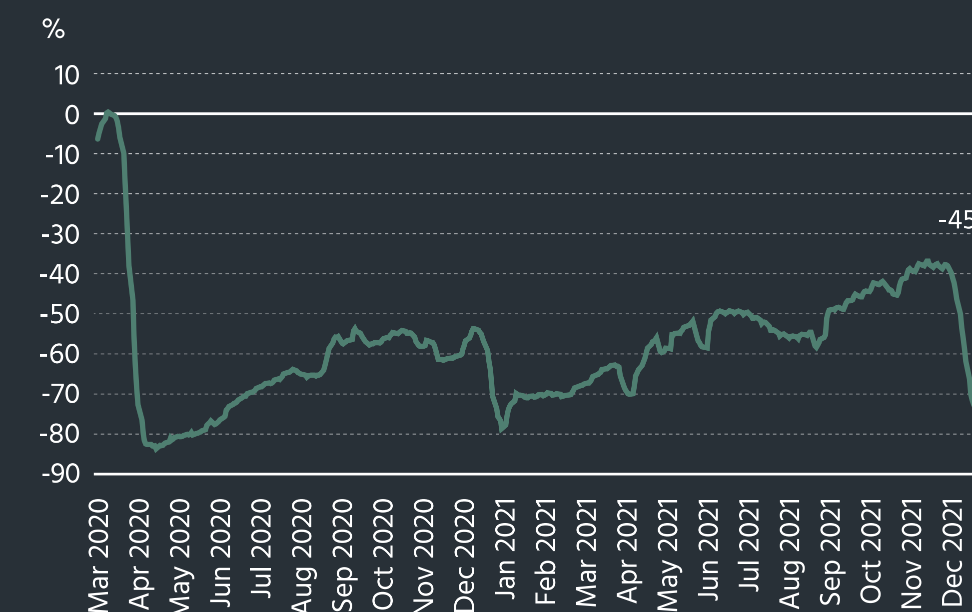
Employment Index

Softening in employment growth following a period of rapid hiring activity, although attempts to rebuild staff capacity continue.

Source: IHS Markit (figures below 50 signify contraction)

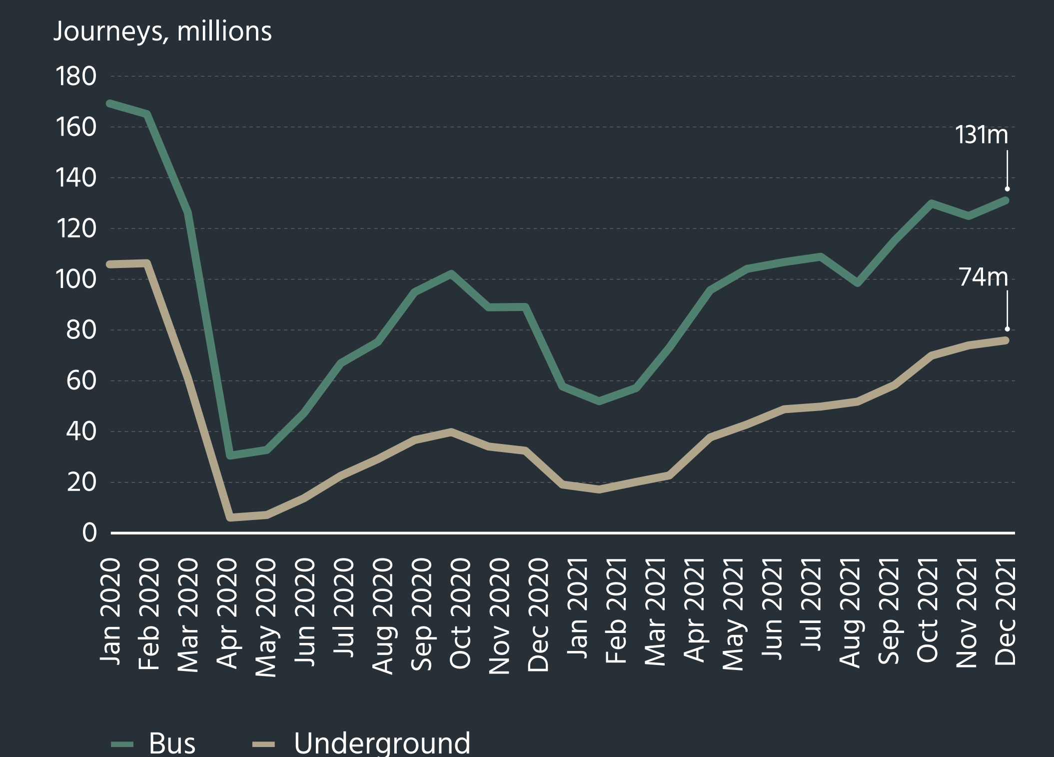
Central London, visits to workplace, difference from pre-pandemic baseline

Sources: Google Mobility Data, Gerald Eve



TfL Journeys by type of transport

Source: Transport for London



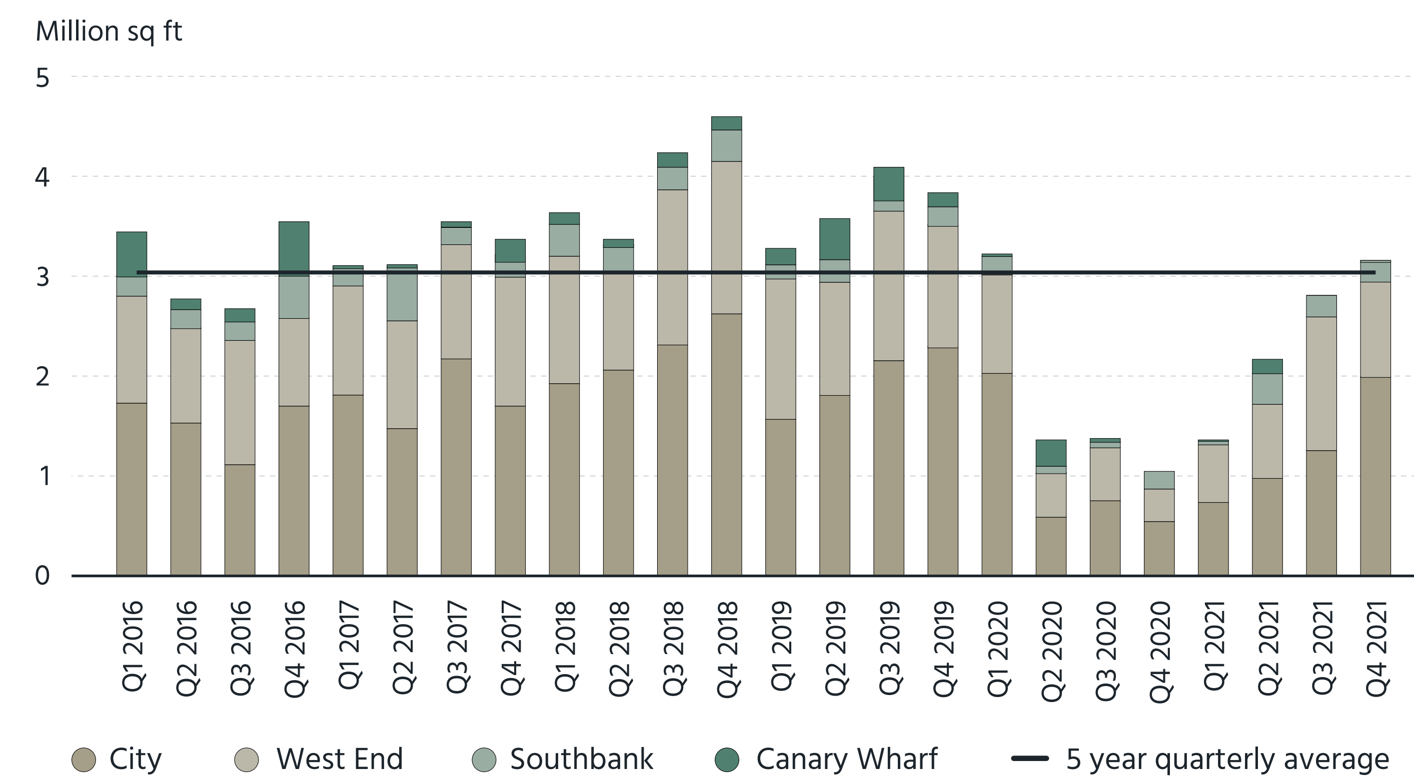
Visits to the workplace were hovering at 39% below baseline for the month of November. However, following the imposition of Plan B restrictions coupled with the Christmas break, visits dropped to a yearly low. They have since recovered with most recent data showing visits are 45% below baseline. The lifting of restrictions should prove positive for office occupancy, maintaining the positive momentum in the occupational and investment markets.

TfL data show the use of public transport steadily increased over Q4. Around 76m underground journeys and 131m bus journeys were made in December. Figures are now only 22% and 30% below the baseline of average monthly journeys in last six months of 2019. The recent lifting of restrictions suggest journeys should continue to trend back to somewhere like pre-pandemic levels in 2022.

OFFICE OCCUPIER DEMAND

London office quarterly take-up by broad market

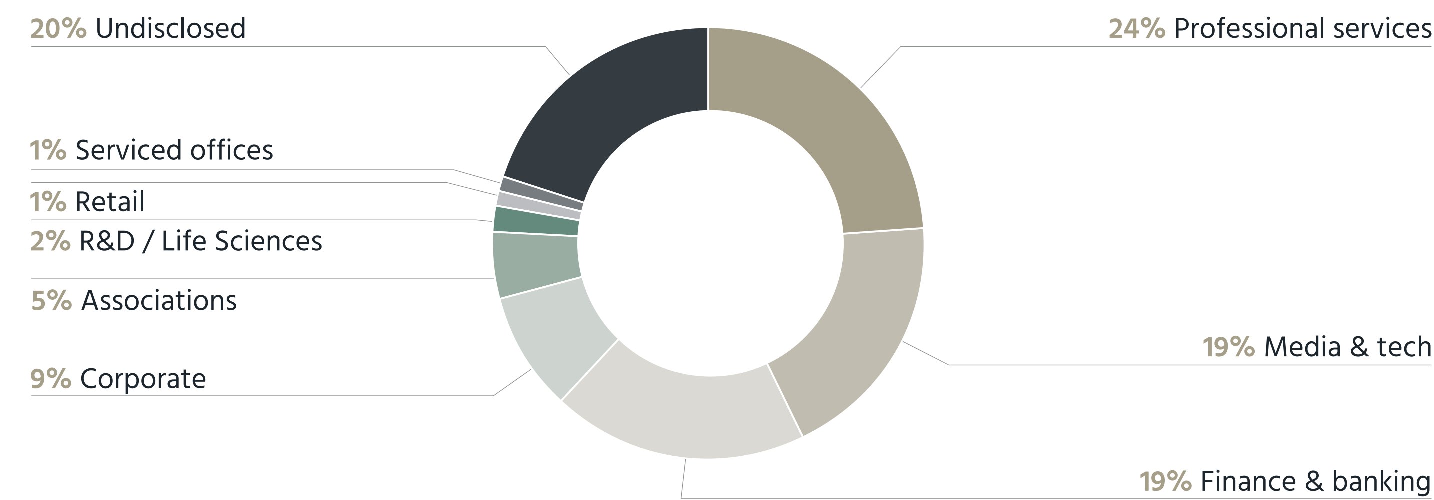
Source: Gerald Eve



The recovery of the London office market continued to gather pace in Q4 2021 as occupier take-up rose to almost 3.2m sq ft. This was 12% higher than Q3, and on par with the pre-pandemic 5-year quarterly average (Q1 2015 – Q1 2020). The resurgence in demand is being driven by interest in Grade A space with the best ESG credentials. The broader City market accounted for most of the activity with almost 2.0m sq ft of take-up. Of the ten largest lettings in Q4, nine were in the City as core occupiers in the professional services and media and tech sectors committed to Grade A space.

Take-up by business sector, Q4 2021

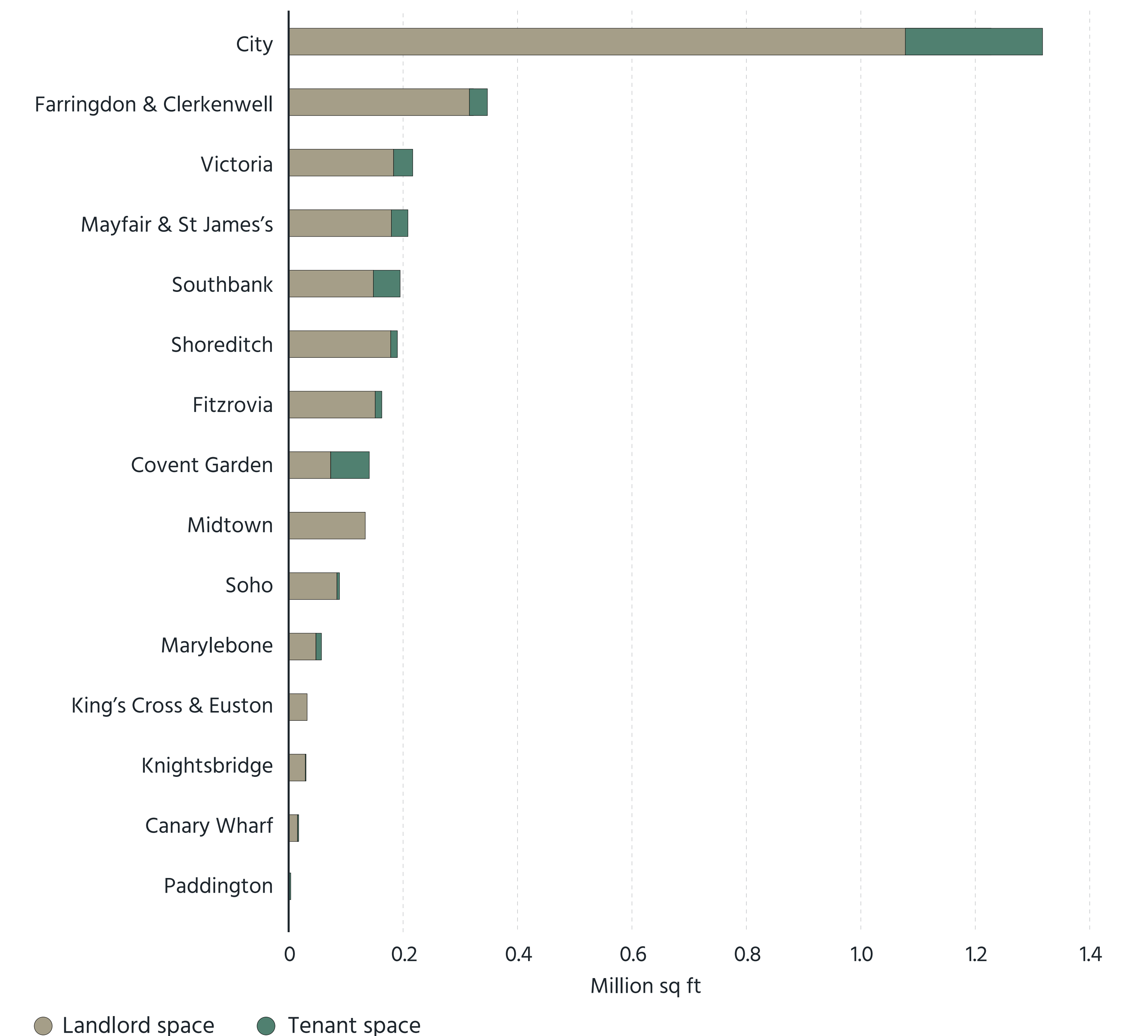
Source: Gerald Eve



Professional services was the most active sector, taking over 750,000 sq ft of space and accounting for almost a quarter of total demand. As a subsector, law firms continued to be active and accounted for 423,000 sq ft in Q4, driven by Allen & Overy's pre-let of 250,000 sq ft at 1 Broadgate. Notable commitments from Snapchat and Apple meant that media and tech was the second most active sector with 610,000 sq ft of lettings, accounting for three of the top five largest deals.

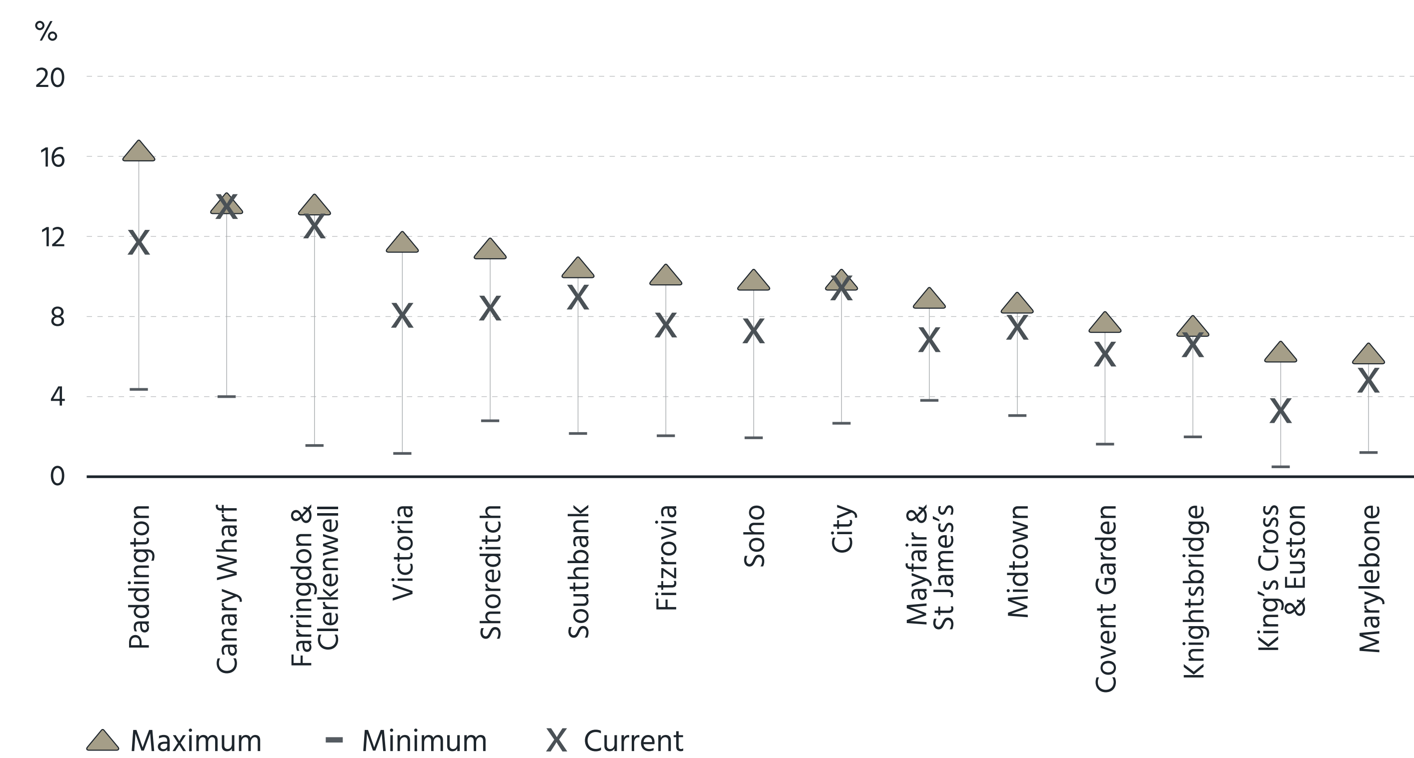
Take-up by submarket and lease type, Q4 2021

Source: Gerald Eve



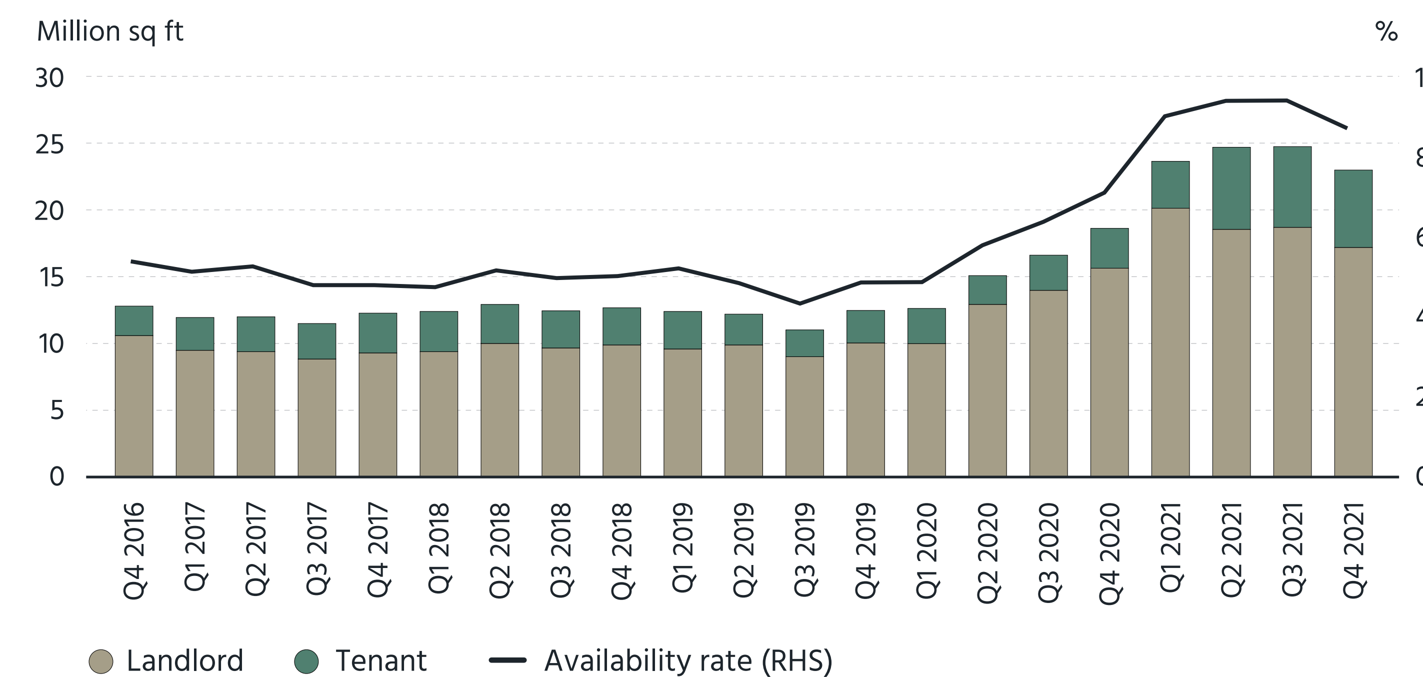
AVAILABILITY & SUPPLY

Availability ranges by submarket, Q1 2013 – Q4 2021
Source: Gerald Eve



London office development pipeline
Source: Gerald Eve

Availability by type of listing and rate
Source: Gerald Eve



Confidence has returned faster than anticipated to the leasing market and we have seen robust levels of occupational activity in the past quarter. With hybrid working the favoured approach for most, occupiers sought out best-in-class space with an emphasis on incentivising employees back while also offering more attractive space to collaborate and host clients and events. Tenants are now voting with their feet for best-in-class space, with environmental credentials carrying increasingly more weight. Ongoing and meaningful engagement between office landlord and tenant is key on how to realise the new modern, wellbeing-orientated environment.

Rhodri Phillips, Partner

On the back of improved demand, the availability rate in London fell by 0.7%pts to 8.7% in Q4, the first meaningful sign of supply stabilisation since the pandemic began. The largest relative quarterly decline occurred in Shoreditch following 100,000 sq ft of lettings on the border of the City in Bishopsgate. Following behind was King's Cross and Euston, and Mayfair and St James's. Positive momentum in the second half of 2021 means many submarkets now sit below the recent peaks in availability reached during the pandemic.

Since the pandemic began, tenant controlled sub-let space has become a more prominent feature of overall supply. Currently 25% of total availability is tenant-controlled, an increase of 1.3%-pts on Q3. The better-quality landlord-controlled space on the other hand is proving attractive to occupiers, with an 8.1%pts reduction in overall availability in Q4. Post-covid occupier demand is focused on quality accommodation, and even though its often more cost-effective, the demand profile for tenant-controlled space is much more limited.

A total of 890,000 sq ft of office space completed in Q4 across nine schemes, bringing total annual completions to 3.4m sq ft in 2021. This volume has fallen short of the expected 7m sq ft which was anticipated to complete at the beginning of the year. Materials shortages caused by complications in global supply chains, inflationary pressures and labour shortages meant multiple schemes set for delivery in 2021 were pushed out to 2022. Several schemes expected to complete in Q4 2021 have been delayed by 3-6 months, increasing the volume of completions expected in 2022 to just under 8m sq ft.

ESG DRIVING A TWO-SPEED INVESTMENT MARKET

The rate of inflation increased again to 5.4% on the CPI measure in December, the highest in decades. The MPC raised interest rates in response to cost pressures and further base interest rate rises are expected this year. The effect of inflation in the construction industry has been stark. Material price growth and wage growth contributed to a sharp increase in overall build costs in 2021. Annual BCIS build cost growth peaked at 11% in November, well above estimates released earlier last year.

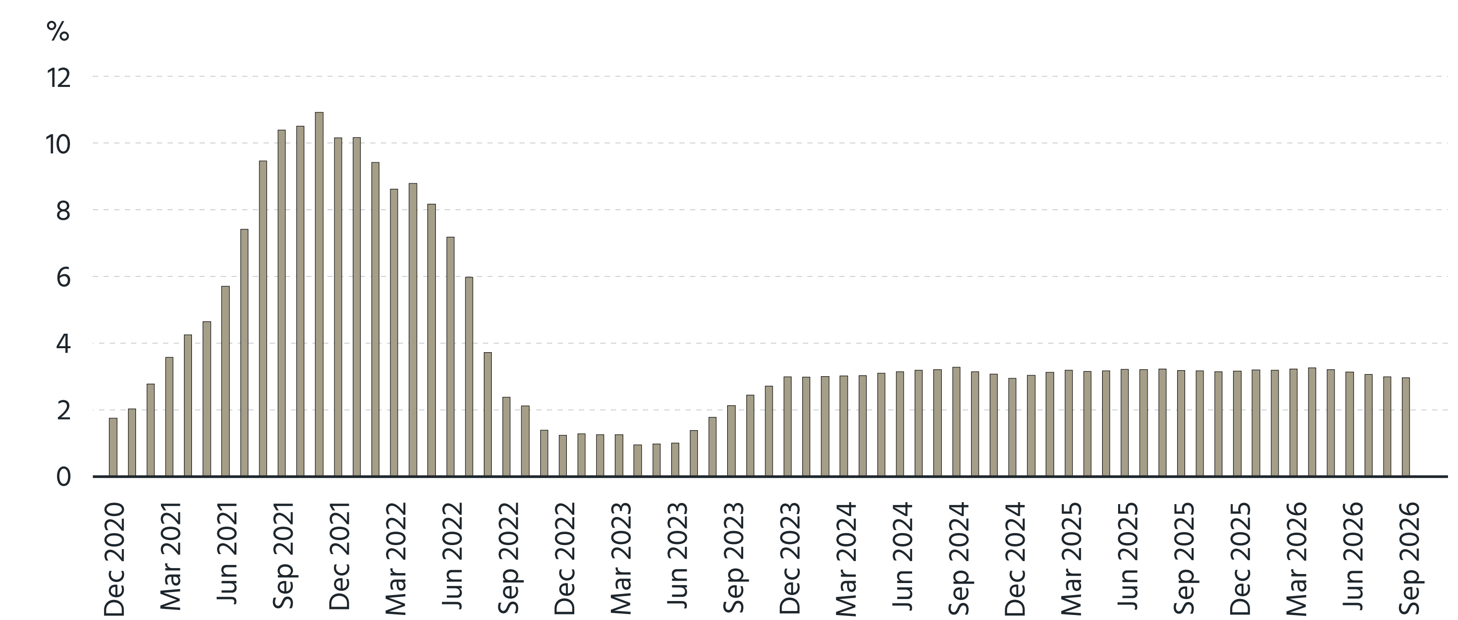
This has put considerable cost pressure on landlords undertaking new projects or refurbishments to try to cater to post-pandemic demand for best-in-class sustainable space. Both occupiers and landlords are alive to further tightening of regulation around ESG and realise the potential cost of inaction. Tenant preference is heavily geared toward high quality offices with strong environmental credentials, evidenced by recent activity in the leasing market. This will continue to drive further demand for refurbishment as landlords look to bring the emissions and energy usage of buildings up to scratch. Construction price pressures are expected to cool this year, with a forecast of 1.2% annual growth in December 2022, which in turn could stimulate activity to reposition poorer quality stock towards the end of the year.

From the beginning of 2020, equivalent yields for tertiary offices in the West End have moved out by 30bps to 4.94%, reflecting a spread of 136bps compared with prime stock. Although the quality of an office is not entirely driven by its sustainability credentials, environmental impact is an increasingly important factor for tenants and will shape letting risk. We expect a similar divergence in yields to occur in other London submarkets this year as the workout and repositioning of poorer quality stock becomes more commonplace.

In future, for poor quality offices - characterised by older stock, low energy ratings and uninspiring fit outs – it will prove harder to achieve previously-attainable rental profiles. A two-speed market will become more pronounced, with enhanced rental growth for newly delivered, ESG focused best-in-class space, and a brown discount for poorer quality stock. Negative rental growth and capital value declines will drag on returns for this space, coupled with low occupancy rates impacting income return. However, opportunities to protect returns by repositioning poorer quality offices are clear and with more stringent ESG regulations likely, this will prove crucial to secure future pricing and liquidity.

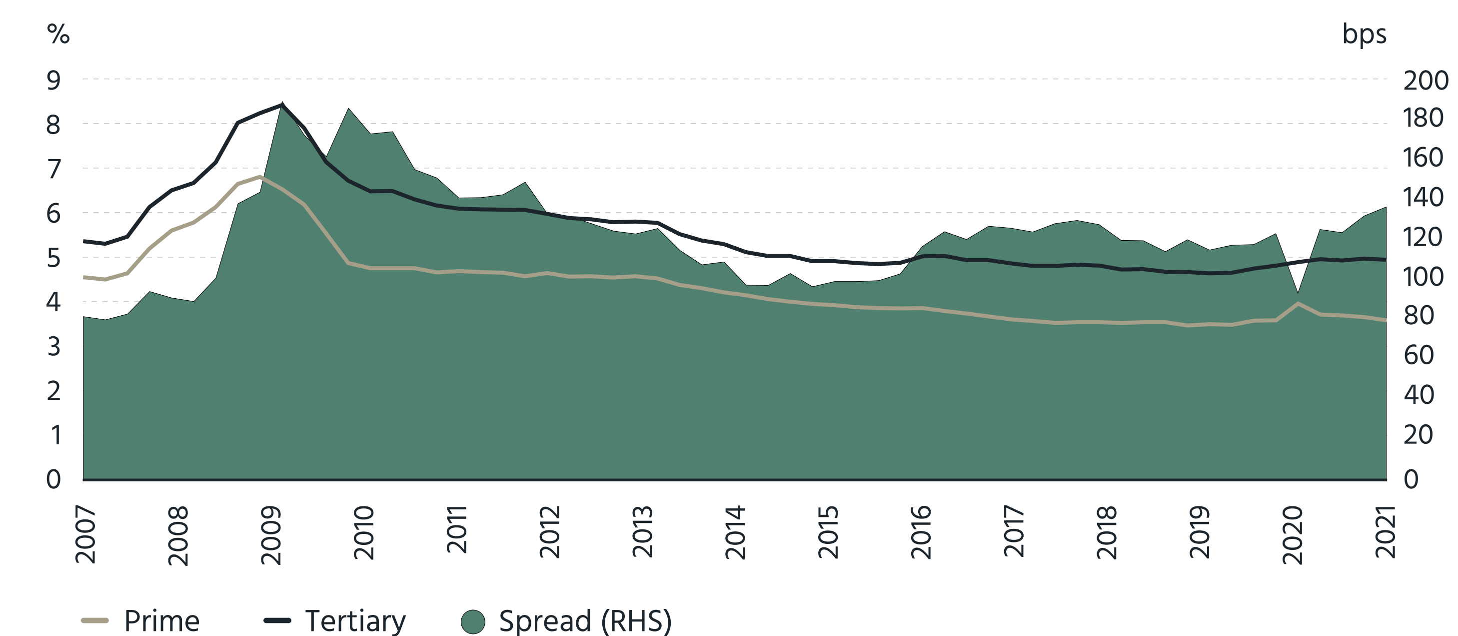
BCIS general build cost index growth

Source: BCIS



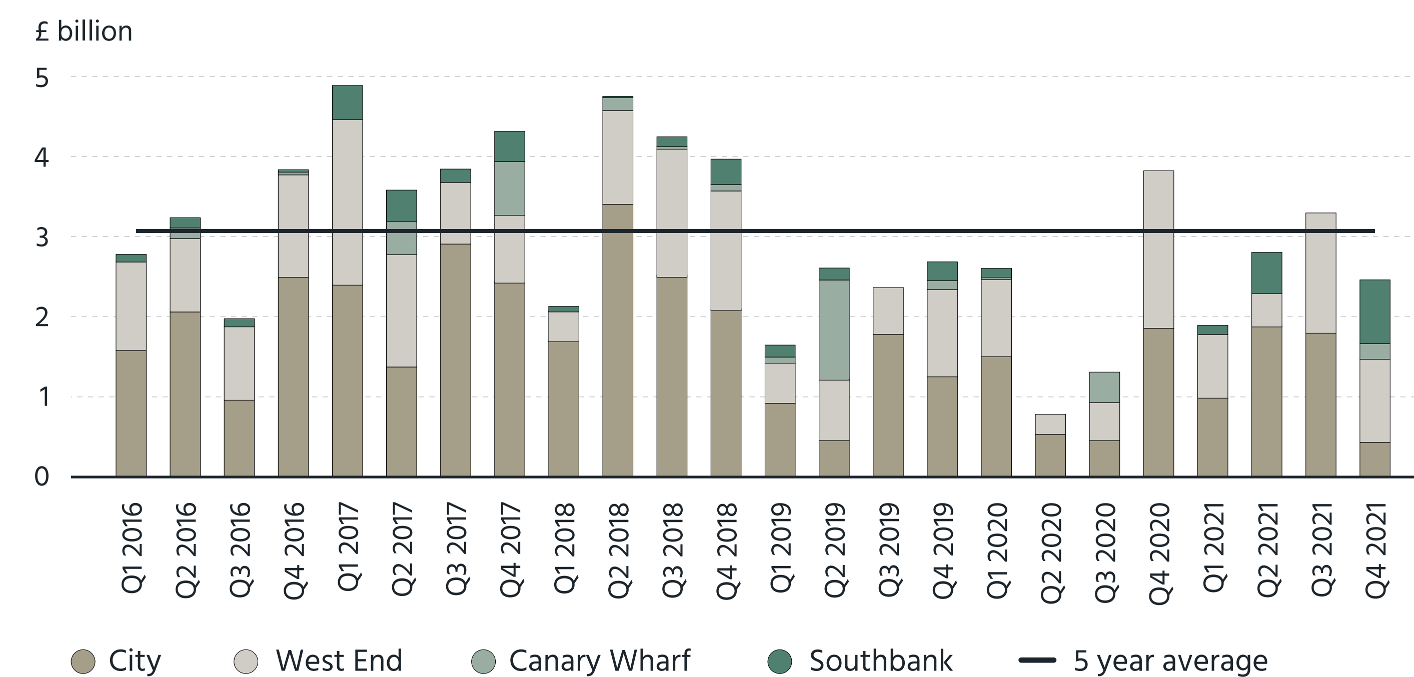
West End equivalent yields by quality

Sources: MSCI, Gerald Eve



INVESTMENT

Quarterly investment volume by broad market
Sources: Gerald Eve, Property Data



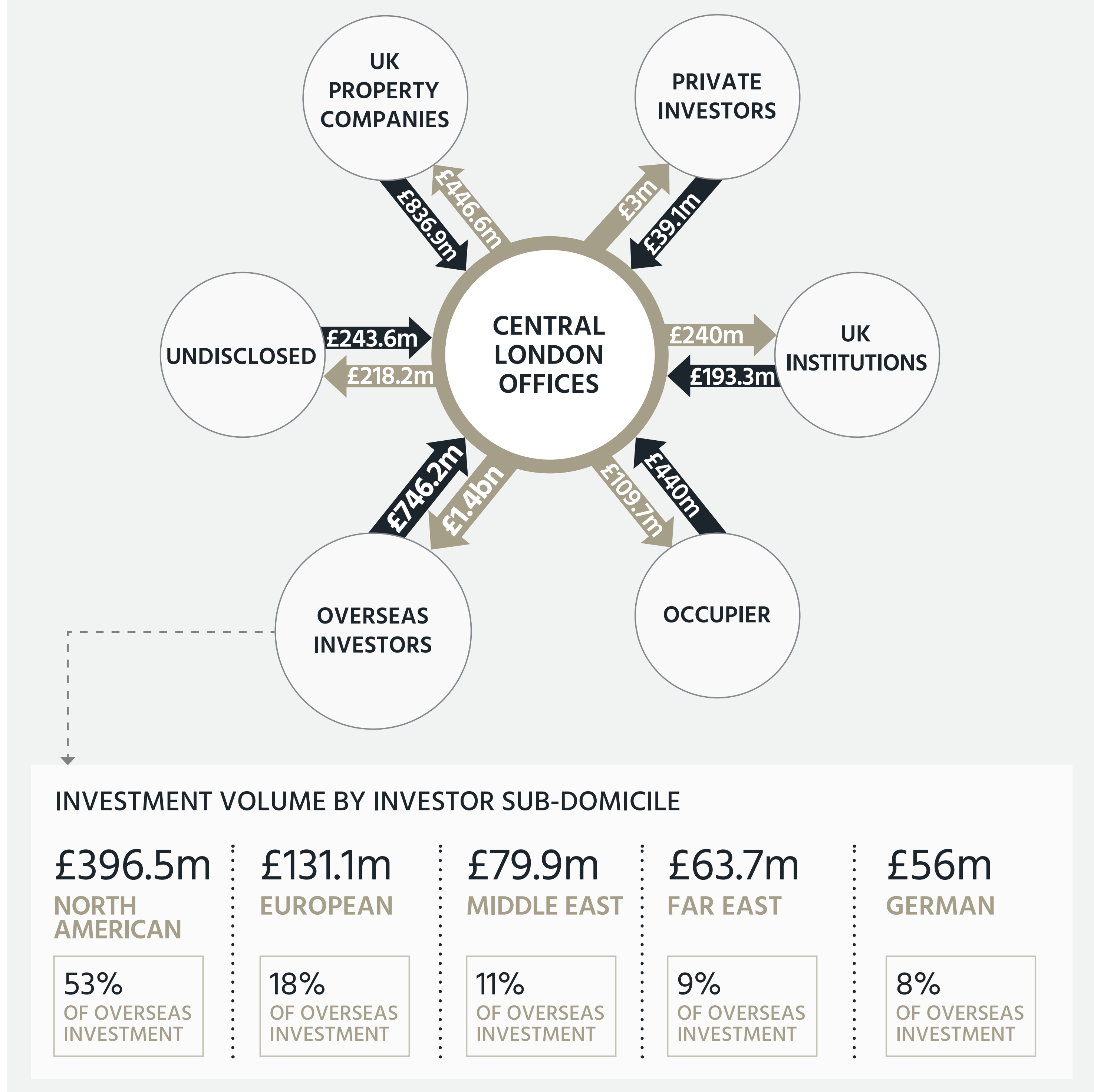
Travel disruption from omicron-related restrictions late last year pushed some deal completions into early 2022, particularly from overseas investors. Consequently, investment volumes in Q4 were just over £2.5bn, a fall of 25% on Q3 and 18% below the 5-year quarterly average. Most activity was focused in the West End, with £1.4bn of acquisitions across 20 transactions, followed by £794m in Southbank. Omnicom Group acquired 2 & 3 Bankside Yards in the submarket for £440m, marking the largest transaction of the quarter. The company has part occupation but intends to consolidate its subsidiaries, OMD and PHD, across the two buildings.

Although not in Q4, Google purchased 41 Central St Giles in January, with the intention to refurbish and consolidate its employees in best-in-class space when completed. Citibank also purchased their current office in Canary Wharf in January, with the occupier committed to full scale refurbishment followed by long term occupation. These kinds of transactions from occupiers may become more commonplace over 2022 as large occupiers look to buy and tailor office space to their specific post-Covid requirements.

UK property companies were the most active buyers in Q4, making £837m of acquisitions across twelve transactions, and disposing of £447m. The largest transaction was ARA Dunedin's purchase of Marble Arch Place, the recently completed BREEAM excellent scheme in Marylebone. Value-add product was also a feature with investors renown for redevelopments notably active. Derwent's acquisition of 230 Blackfriars touted for repositioning in the medium term, as well as Dorrington's purchase in the Temple Chambers are evidence that there's increasing appetite to take on developments for repositioning in core locations.

Overseas investors were highly active on the sell-side with disposals amounting to £1.4bn over eleven transactions, almost double the acquisition volume of £746m. By sub-domicile, German investors were the largest sellers following DWS's sale to Omnicom. Far Eastern investors were the next largest seller group, driven by IGB Corporation's £200m sale of 18 Blackfriars, a 1.8-acre development site acquired by Hines. The site has an estimated £1bn of gross development value and will provide new office space within a mixed-use development.

CENTRAL LONDON OFFICE CAPITAL FLOWS, Q4 2021
Source: Gerald Eve, Property Data



OUTLOOK

Office rents remained stable in Q4 and for the first time since the pandemic began, incentives shifted in based on positive sentiment. Tenants are competing for Grade A space and some negotiating power has shifted back to landlords. We expect there to be isolated, but potentially strong, rental growth in best-in-class space in core locations with excellent ESG credentials, however, lower grade rents are likely to fall, with weakening demand for such space driving increased market polarisation in 2022.

Whilst availability looks to have peaked in many London submarkets, as occupiers implement relocation plans and seek to tailor space to hybrid working policies and ESG targets, supply is likely to remain above average in the medium term as the market adapts. Especially as plans are likely to be linked to lease events. Construction cost pressures in the first half of 2022 may further delay or hinder the delivery of space and the implementation of office strategies.

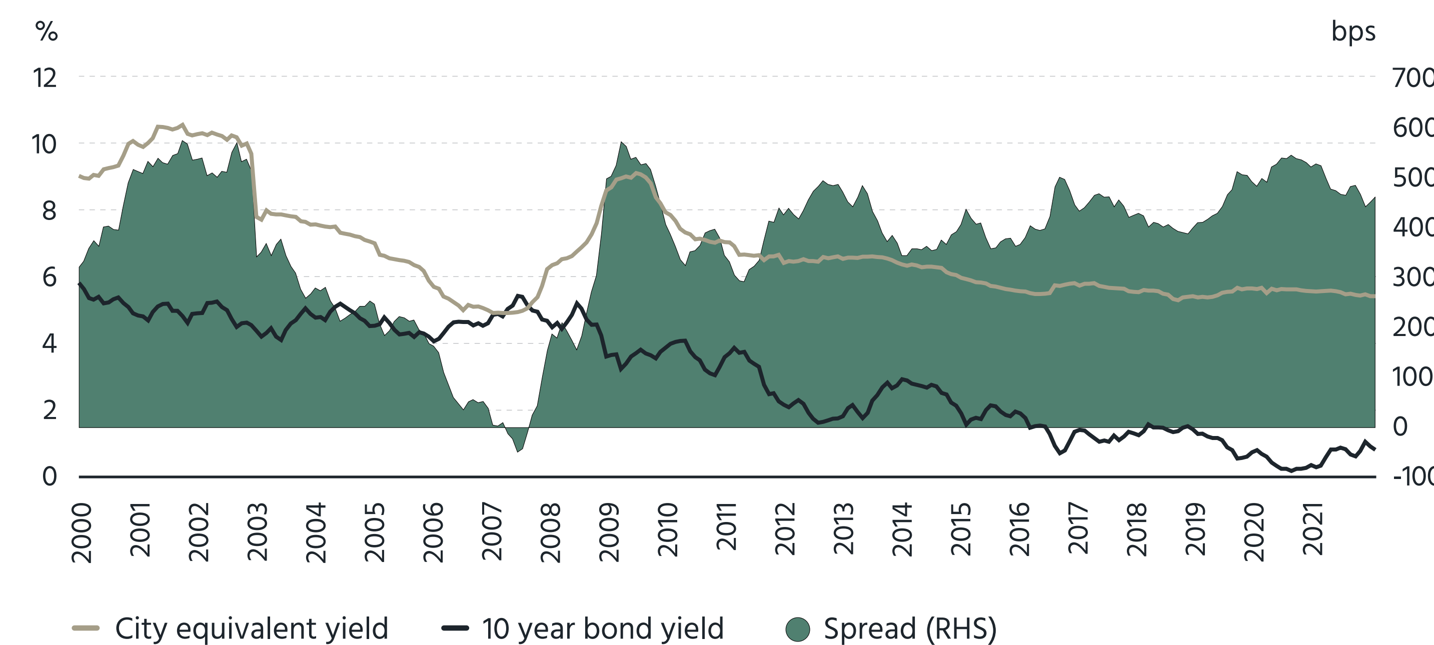
Equivalent yields across London tightened in Q4 driven by investor demand for best-in-class space. Monthly data from MSCI for December 2021 show equivalent yields in the City reached 5.3%, an inward movement of 15bps compared with January. Similarly, keener pricing in the Midtown and West End meant there was a larger inward shift of 44bps to 4.4% over the same period, the lowest equivalent yield recorded since MSCI data began. There's likely to be continued market polarisation between prime and tertiary assets with weak ESG credentials given the time needed to formulate and implement plans and the associated cost pressures.

The Bank of England raised interest rates from 0.1% to 0.25% in December, and again to 0.5% in February. The current hawkish stance points to at least two base interest rate rises this year. Recent bond yield data show an upward shift of 40bps from 0.8% to 1.2% from the MPC decision date in December to the end of January. Oxford Economics have forecast bond yields to reach 1.5% by the end of 2022. Current spreads between the City (440bps), and Midtown and West End (340bps) look attractive despite the recent compression and uplift in the risk-free rate, and provides sufficient headroom for further movements this year.

> Whilst the Omicron variant is still hampering some overseas investment activity, the government's stance encouraging people back to their offices has underpinned improved occupier confidence and investor demand. We expect the divergence of performance on both leasing and investment metrics to amplify between the good and poor-quality space over this year. However, where there is divergence, there is opportunity, with stock selection being key. Value-add refurbishments and development opportunities where there is a focus on environmental enhancement will present investors with the greatest prospects to capture yield compression and rental growth from underperforming assets.
>
> **Lloyd Davies, Partner**

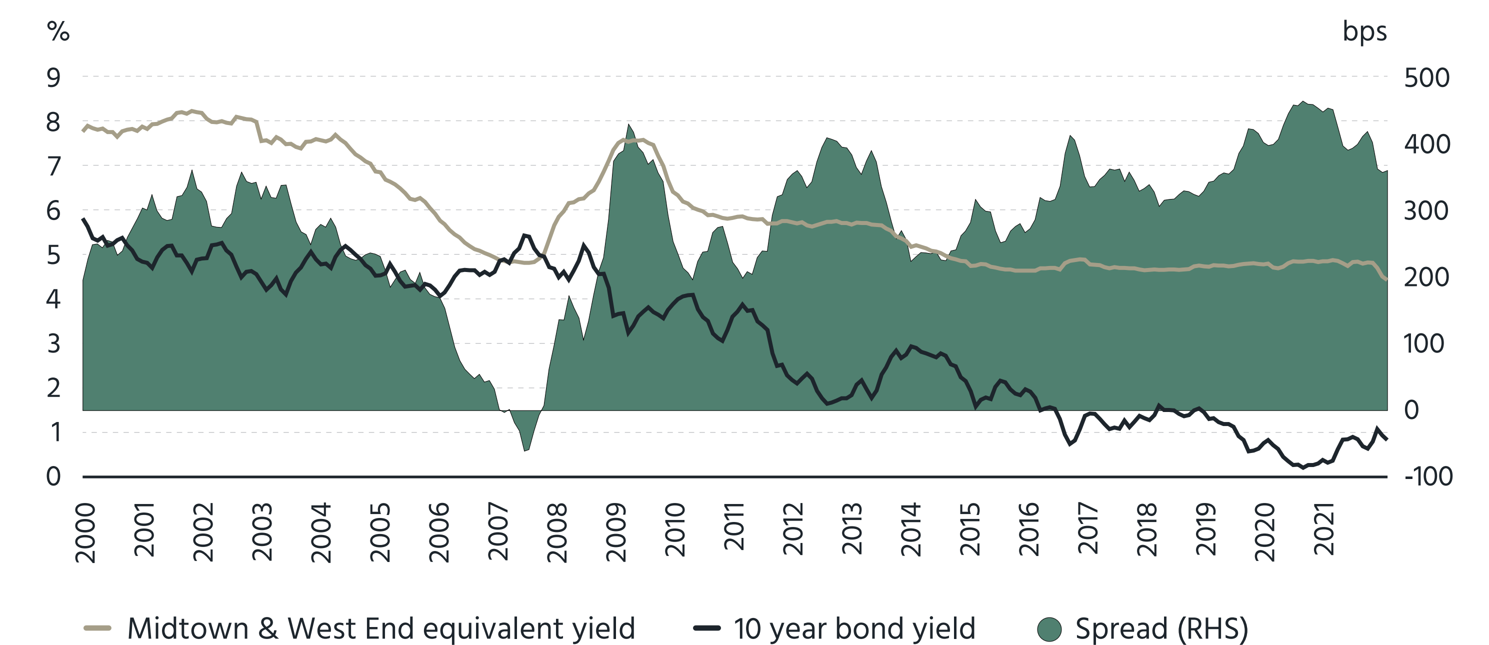
City office yield and spread

Sources: Gerald Eve, MSCI, Oxford Economics



Midtown and West End office yield and spread

Sources: Gerald Eve, MSCI, Oxford Economics



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GERALD EVE IN THE MARKET

Ilona Rose House, Soho
Gerald Eve has been appointed office leasing advisor by Soho Estates on the 300,000 sq ft mixed-use development, due to complete in Q2. With almost half the office content already committed, up 80,000 sq ft of brand new offices, featuring 10,000 sq ft of landscaped terraces, remains available.

Egmont House, 25-31 Tavistock Square, WC1
Acting on behalf of Birkbeck, University of London, Gerald Eve has successfully sold the vacant freehold interest to Egmont House, Bloomsbury, within London's Knowledge Quarter. The 14,404 sq ft office was sold to The Methodist Church for their own occupation for a sum of £14.6m.

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