LONDON MARKETS

London office property
performance and key themes

July 2022

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LONDON OFFICE MARKET SUMMARY

London office take-up increased to just over 3.3m sq ft in Q2 2022, the highest since Q4 2019. However, sentiment points to a slowdown in the coming months with uncertainty over the current economic and political backdrop.

Based on letting evidence this quarter, Grade A rents in six out of the 16 submarkets have moved on, with the strongest growth in Mayfair & St James' and Soho. Incentives have moved inward across four submarkets: Covent Garden, Fitzrovia, Mayfair & St James' and Soho.

Availability ticked up to 8.5% in Q2, an increase of 0.4 percentage points compared with the previous quarter. This was principally the result of the completion of several delayed large refurbishments rather than the start of an upward trend.

Recent forecasts suggest that new-build cost inflation in 2022 and 2023 will be a further 1.7% and 2.9% above where they were expected back only in March-22. For refurbishments, particularly brown-to-green, costs have increased to an average £400 per sq ft, compared with £300 per sq ft a year ago.

Investment transactions of London offices was just over £1.5bn in Q2. Barring the onset of the covid pandemic, this marks the lowest quarter of investment activity in London offices in over a decade. Debt costs and financing terms are expected to pause activity over the summer as investors take stock.

Yields are expected to be flat over the year on aggregate, with yield compression in H1 to be effectively reversed in H2. Market rental growth will feature in the higher-quality end of the market. However, Grade B and below rents will fall as the market becomes ever more polarised.

3.3m sq ft ▲ Take-up, Q2 2022	**8.5%** ▲ Availability rate, Q2 2022
£1.5bn ▼ Investment volume, Q2 2022	**14.5%** ▲ Construction cost Dec '20 vs Jun '22

THE LONDON ECONOMY

LONDON AND THE REST OF UK GVA

	2021	2022	2023
London	6.7%	4.5%	2.1%
UK excl. London	7.8%	3.7%	1.5%

ILO UNEMPLOYMENT RATE

	2021	2022	2023
London	5.8%	4.6%	4.3%

WORKPLACE-BASED EMPLOYMENT GROWTH

	2021	2022	2023
Office	1.4%	1.2%	1.3%

Source: Oxford Economics

LONDON FLASH INDICATORS PMI JUNE 2022

60.3 ▲

Business Activity Index

A monthly acceleration buoyed by increased travel activity and new orders, but risk remains to the downside.

54.9 ▼

New Business Index

Monthly deceleration as firms report concerns over rising costs and inflation, and slowdown in client spending.

64.3 ▼

Future Activity Index

Lowest level of sentiment since May 2020, with recession fears noted in responses.

58.5 ▼

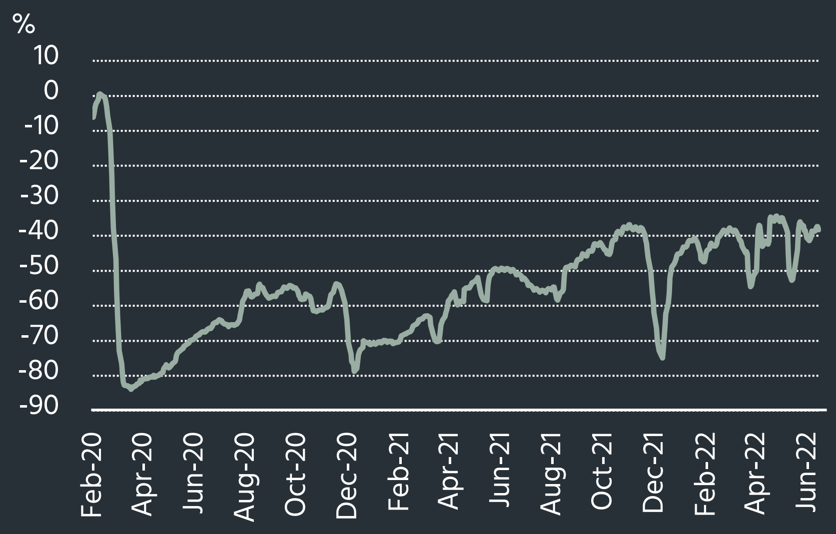
Employment Index

Slight deceleration in jobs growth. But London recorded a stronger rate of job creation than other UK regions.

Source: IHS Markit

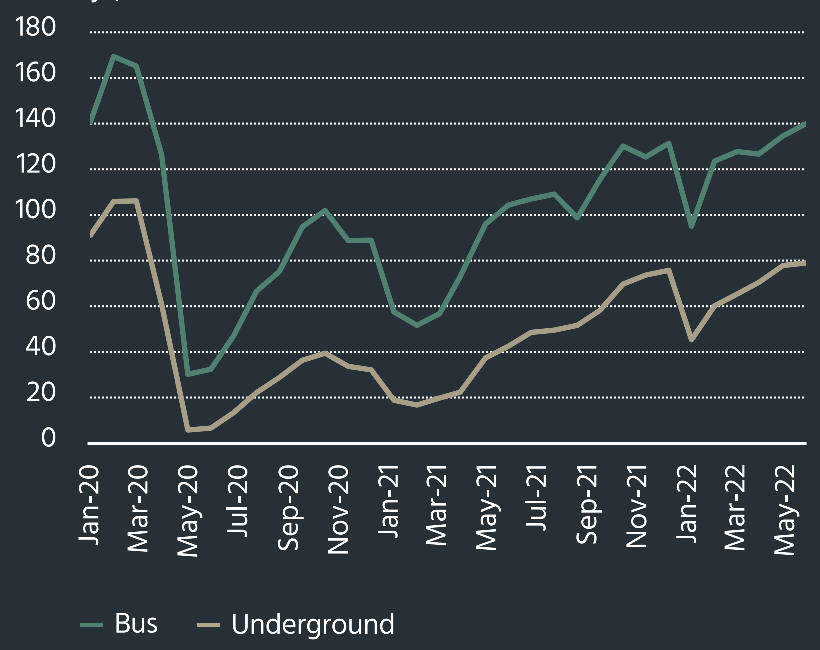
Central London visits to workplace, difference to pre-pandemic baseline

Source: Google mobility data, Gerald Eve



TfL journeys by type of transport

Source: Transport for London

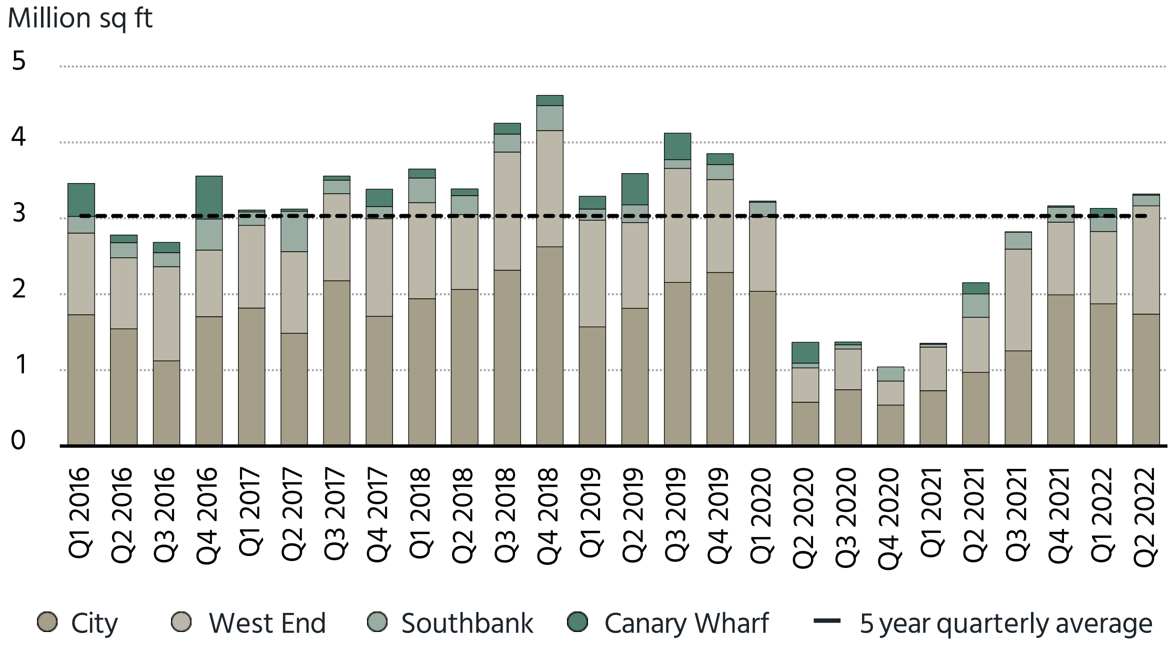


Visits to workplace fell at the beginning of June due to the extended Platinum Jubilee bank holiday, hitting a low of 52% below the baseline. This has since ticked back up and on average for the first week of July visits to workplace were 38% below the baseline. However, many employees have cited increased travel costs as a limiting factor for going to the office, so this figure could be eroded while inflation squeezes real incomes and the cost of living mounts.

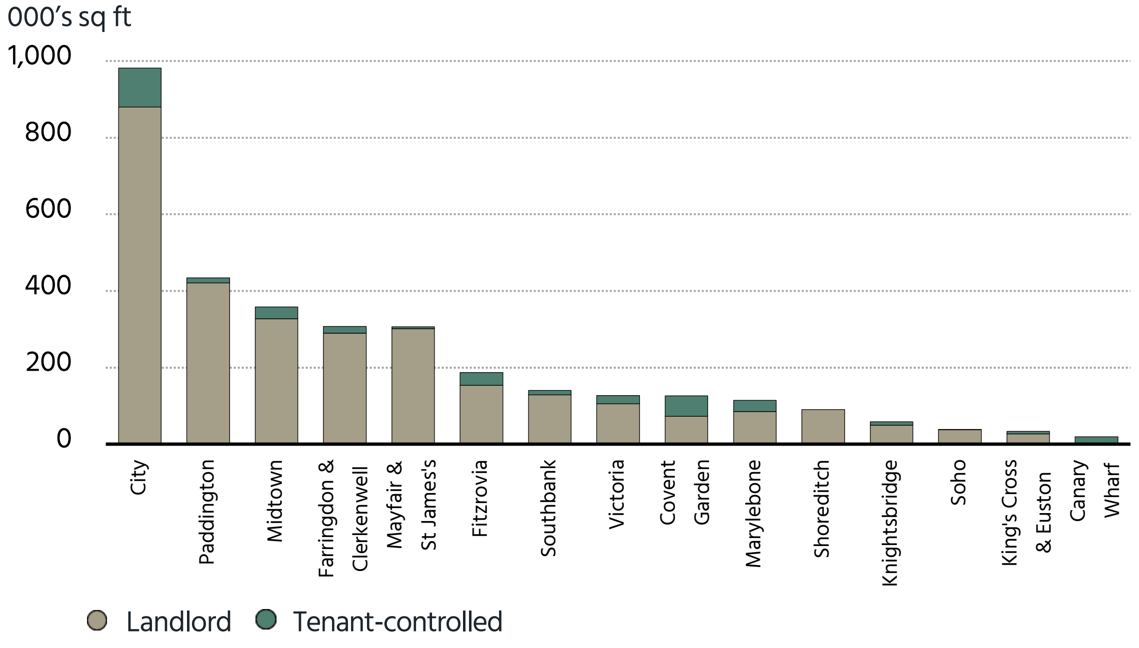
Recent TfL data show the use of public transport in London reached its highest level since the first months of 2020. Bus journeys increased by 4% month-on-month to 140m, while underground journeys rose by 1.3% over the same period to 79m. TfL's increased fares have not yet negatively impacted underground demand, with journey growth of 21% since the change.

OFFICE OCCUPIER DEMAND

London office quarterly take-up by broad market
Source: Gerald Eve



Take-up by submarket and lease type, Q2 2022
Source: Gerald Eve



Strong take-up this quarter was driven by a robust appetite for offices that meet ESG requirements and further characterised the flight-to-quality we've seen in the market as more staff return to the office. However, we expect the Q3 summer months to be far less acquisitive as companies take stock of the political and economic environment, both within the UK and across Europe. On a positive note, we expect that this pause in activity will rebound in Q4, although to what extent is harder to predict.

Patrick Ryan, Partner

London office take-up increased to just over 3.3m sq ft in Q2 2022, the highest since Q4 2019. This was an increase of 6% compared with the last quarter and 9.5% above the 5-year quarterly average. Occupational activity in the City market fell marginally by 7%, but total activity in the West End was up by a half in Q2. Total take-up in the broader markets amounted to 1.7m sq ft and 1.4m sq ft in the City and West End, respectively. Total activity in Southbank and Canary Wharf reached 141,000 sq ft and 19,000 sq ft in turn.

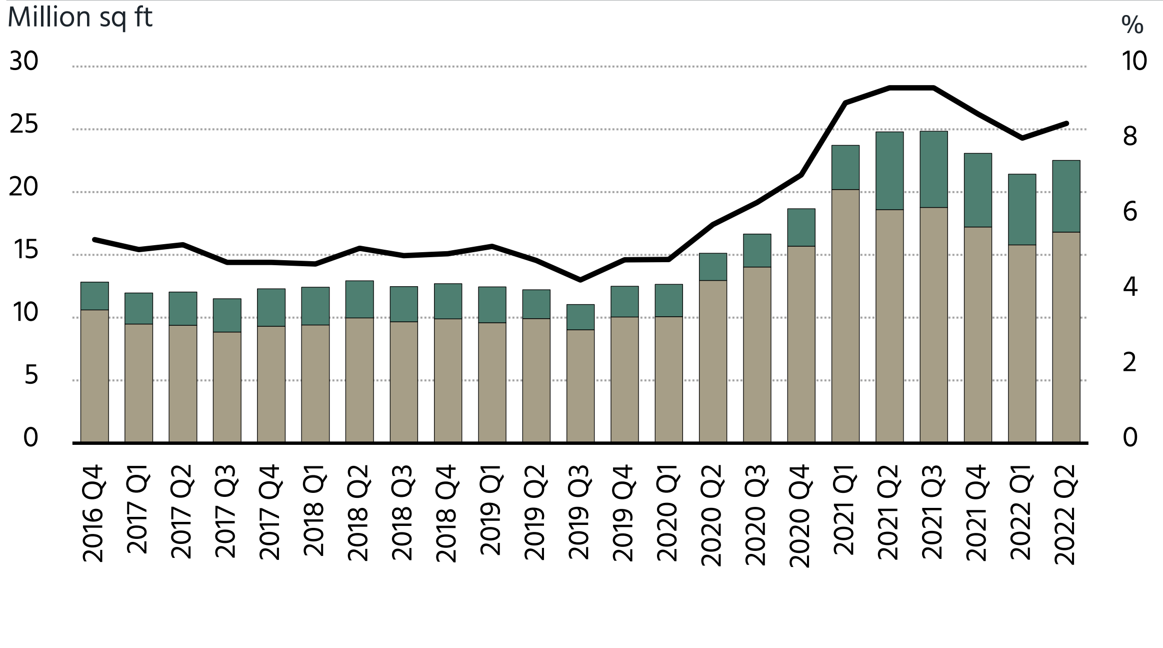
By submarket, the City and Paddington were the most active in Q2. This quarter was characterised by a large volume of pre-let activity on floorplates above 20,000 sq ft, with this segment accounting for a third of overall take-up (1.1m sq ft). In the City, Kirkland & Ellis and Chubb took a combined 300,000 sq ft in 40 Leadenhall, known as Stanza London. Paddington Square is now fully let prior to completion, with Capital Group, DS Smith, and Payment Sense among the prospective occupiers across 360,000 sq ft of new Grade A space located directly adjacent to Paddington station.

Based on letting evidence this quarter, Grade A rents in six out of the 15 submarkets have moved on, with the strongest growth in Mayfair & St James' and Soho. Respectively, rents in these submarkets both increased 8.3% from £120 to £130, and £90 to £97.50. Farringdon & Clerkenwell also had robust growth, with rents moving on from £80 to £85 (6.3%). Additionally, incentives have moved inward across four submarkets. Covent Garden, Fitzrovia, Mayfair & St James' and Soho incentives have moved in by a uniform three months on a typical 10-year lease.

AVAILABILITY

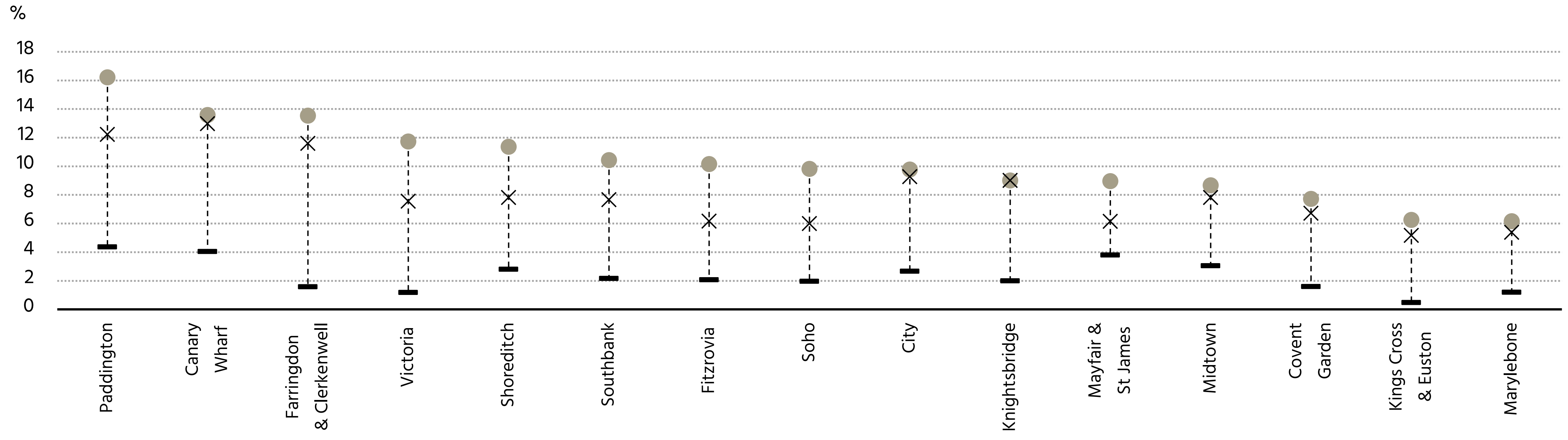
Availability by type of listing and rate

Source: Gerald Eve



Availability rate, historical range by submarket, Q1 2013 – Q2 2022

Source: Gerald Eve



The availability rate ticked up in Q2 to 8.5%, an increase of 0.4%-pts compared with the previous quarter. Given the large volume of pre-let activity, net absorption in offices this quarter will have been generally more muted than usual. Moreover, several large refurbishments delayed by issues in the construction sector came onto market in Q2, particularly in Knightsbridge and King's Cross. Consequently this uptick is more of a one-off than the start of an upward trend. In fact, this higher quality space is likely to attract greater interest from occupiers and help drive more sustained future take-up.

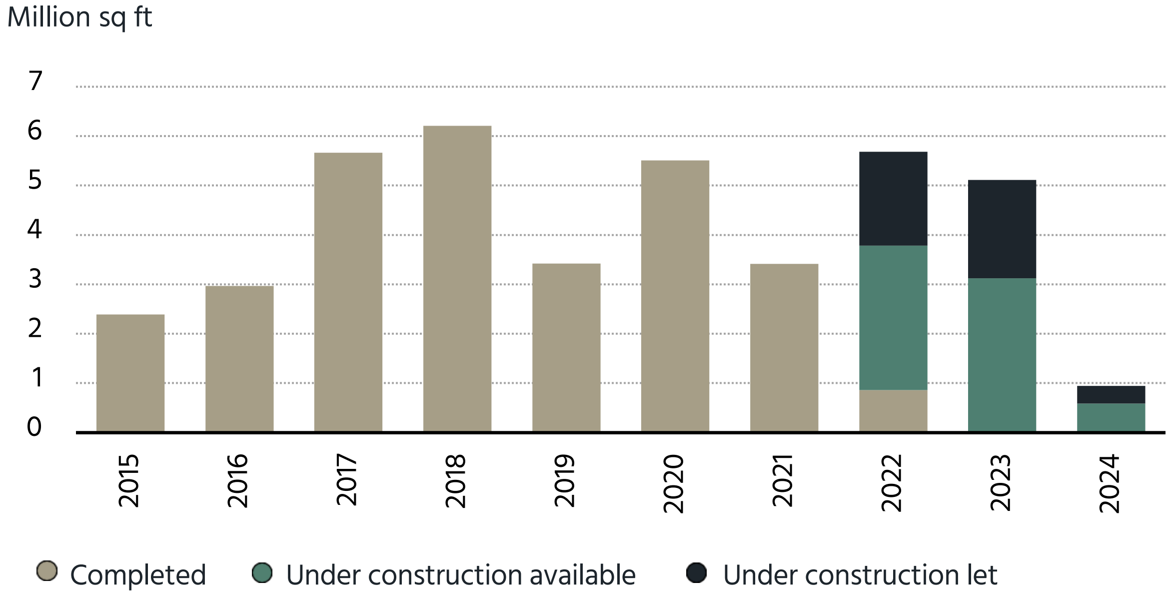
The volume of tenant-controlled space rose by 1.2% to 5.7m sq ft in Q2, which makes up just over a quarter of overall availability. Take-up of tenant-controlled space was particularly low this quarter, with an estimated 332,000 sq ft taken overall, only 10% of overall demand. This was the lowest sub-let space absorption since Q1 2021. Over the past year, just under 2.7m sq ft of tenant controlled-space has been leased, most of which was the higher-quality stock. What remains is less desirable given new demand characteristics and, as it stands, is likely to remain a structural feature of overall availability over the medium term.

New-to-market office space affected availability rates in smaller submarkets markedly in Q2. In Knightsbridge availability rose from 7.5% in Q1 to 9% when both 1 Knightsbridge and 7 Holbein Place came to market totalling 140,000 sq ft and accounting for 4% of total current stock. Meanwhile in King's Cross & Euston, over 100,000 sq ft became available in 338 Euston Road, featuring newly renovated lab space. This is unlikely to remain on the market for long, however, given the attractiveness of the knowledge quarter to prospective life sciences occupiers and the lack of existing lab-enabled space.

DEVELOPMENT

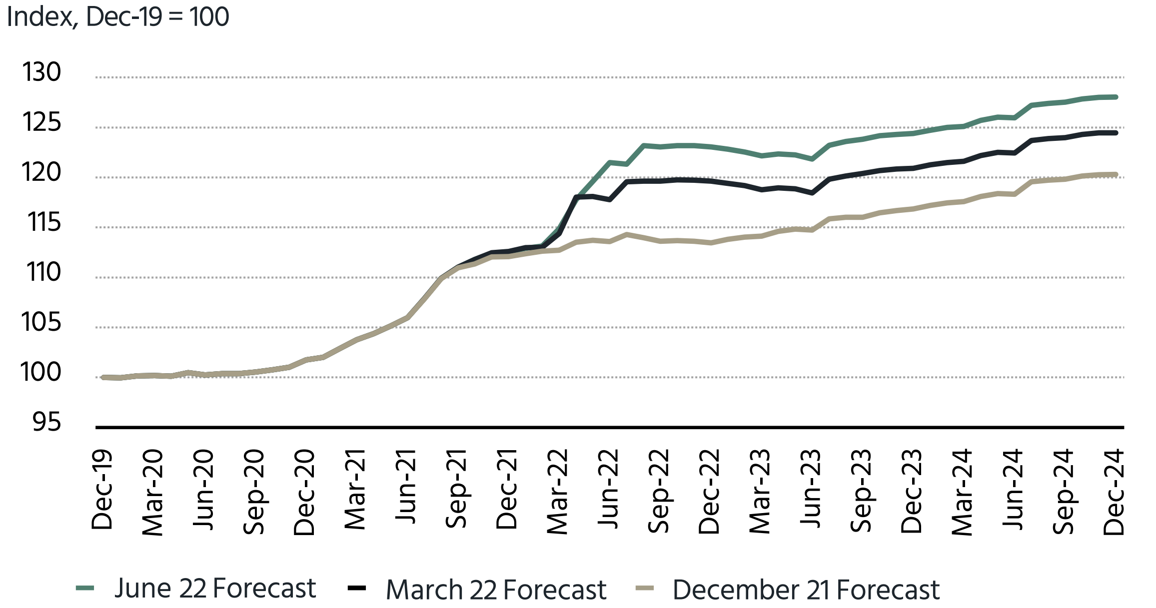
London office development pipeline

Source: Gerald Eve



BCIS general build cost index

Source: BCIS



> Developers are conscious of the heightened expectations of office occupiers on environmental performance, well-being and sustainability. It is also apparent that space with these attributes are in very tight supply, especially in the West End. For existing sites that have the potential to provide this space, developers are still looking to proceed despite the challenges of build costs. However, they are mindful of what is a restrictive and increasingly challenging regulatory climate, especially where major physical change, as opposed to cosmetic enhancements, are proposed.
>
> **James Wickham, Partner**

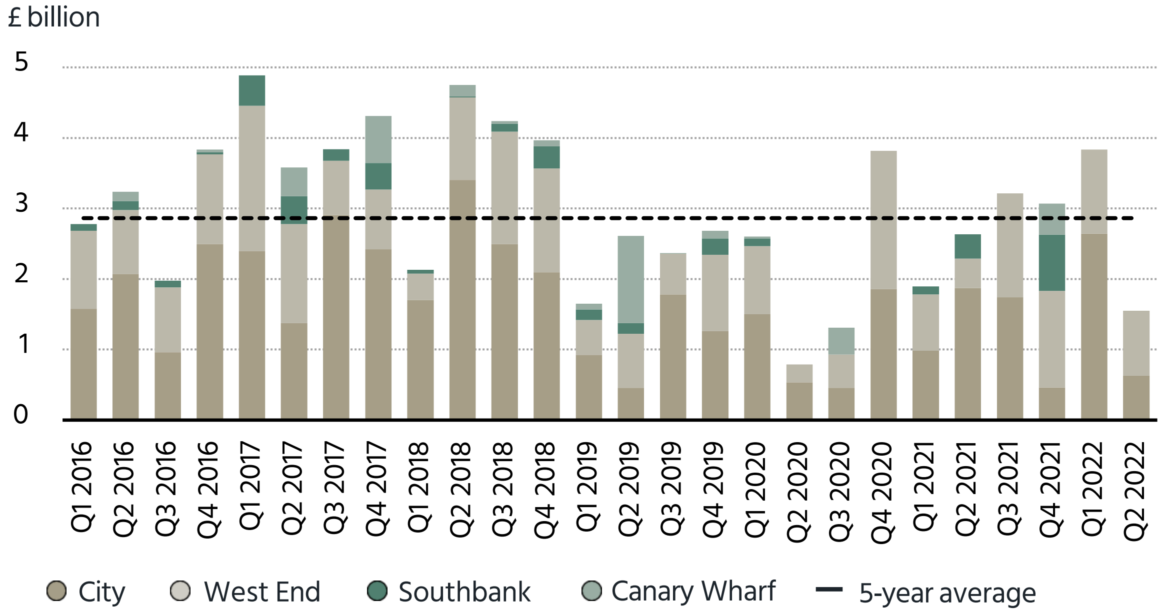
Several new developments continue to lag original delivery schedules, with schemes such as Ilona Rose House and Paddington Square originally cited for practical completion in the latter stages of Q2, now expected to complete in late July or August. This is happening across London and the various postponements mean it is now highly likely there will be a material reduction in the 7.7m sq ft of completions for 2022 that was expected earlier this year. There is an estimated 4.8m sq ft left to complete in 2022, with only just over 850,000 sq ft completed by the half-year point.

Only half a million sq ft completed this quarter across five schemes, the largest of which was Derwent's 209,000 sq ft 1 Soho Place. The recent high volume of pre-let take-up has fed through into this year's pre-let development figure, which now stands at 40% of all stock under construction. For 2023, the pipeline is for 5.1m sq ft, of which just under 2m sq ft is pre-let. There is increased appetite for developers to take on full-scale refurbishments, as opposed to ground-up developments that have the faster growing build costs of the two.

Build cost inflation continues to rise, with another increase to forecasts. On average, build costs in 2022 and 2023 are expected to be a further 1.7% and 2.9% above the March-22 forecast. For refurbishments, particularly brown-to-green, costs have increased markedly, with some schemes reporting an increase to an average £400 per sq ft, compared with an average £300 per sq ft a year ago. Despite the stark increase, comprehensive refurbishments remain cheaper than ground-up schemes. This will change the pipeline over the coming two years, with developers and landlords being increasingly selective on office developments and refurbishments.

INVESTMENT

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



Investment transactions of London offices was just over £1.5bn in Q2, a fall of 60% compared with Q1 and 45% below the 5-year quarterly average. Barring the onset of the covid pandemic, this marks the lowest quarter of investment activity in London offices in over a decade. The West End accounted for the majority of activity, with £919m transacted across four transactions, two-thirds of which was GIC Real Estate's purchase of a 75% stake in the Paddington Central Scheme for £694m. In the City, investment totalled £631m with Kingboard's acquisition of 2 London Wall Place for £294m the largest individual transaction.

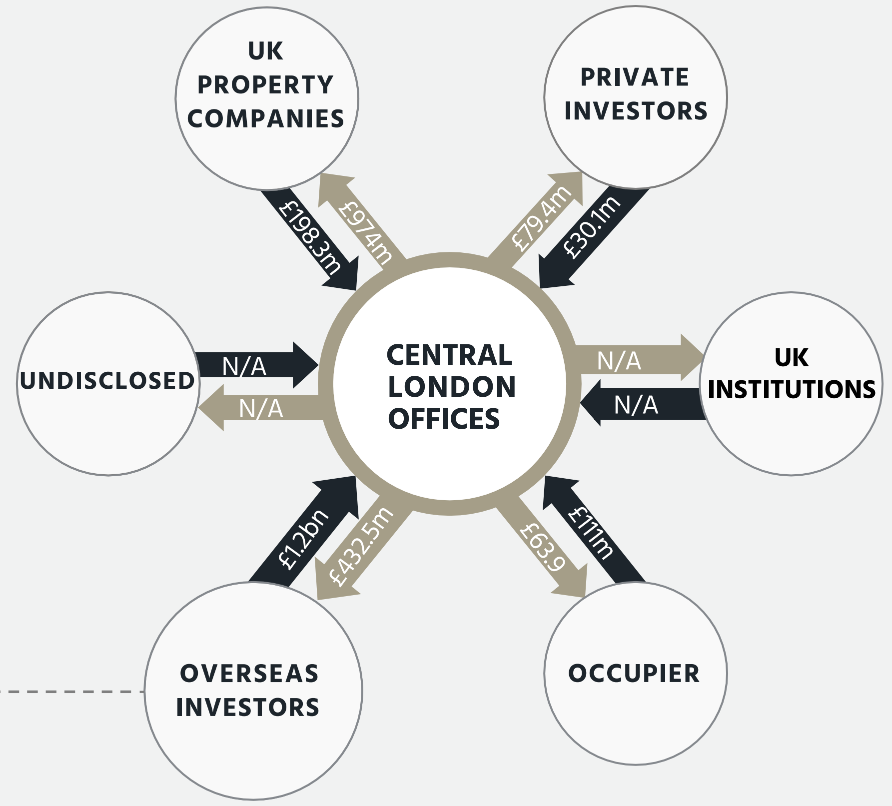
On the buy-side, overseas investors dominated with £1.2bn invested in Q2 over four transactions. APAC investors accounted for almost all overseas activity from three transactions. UK property companies were on the sell-side to APAC buyers for Paddington Central (£694m) and 32-50 Strand (£195m), sold by British Land and Landsec, respectively.

Both companies cited the reason for selling as recycling capital out of mature assets, a factor which could be a feature of investments in the near term as purchasers seek guaranteed return on investment during an uncertain period.

The economic backdrop of high inflation and increasing debt costs mean the coming months will be quiet for London office investment. The SONIA rate on a 5-year swap was up more than five-fold since this time last year – 0.4% in July 21 vs. 2.3% in July 22. Acquisitions using leveraged funding are no longer as economically viable given financing costs, with this expected to affect both the investment and development market.

While financing costs remain high, the buyer pool will shallow, further compounding the likelihood of a sluggish summer. Some investors have opted to withdraw prospective and recent sale campaigns from the market, expecting to achieve more favourable pricing when financing conditions look more favourable to potential buyers.

CENTRAL LONDON OFFICE CAPITAL FLOWS, Q2 2022
Source: Gerald Eve, Property Data



INVESTMENT VOLUME BY INVESTOR SUB-DOMICILE

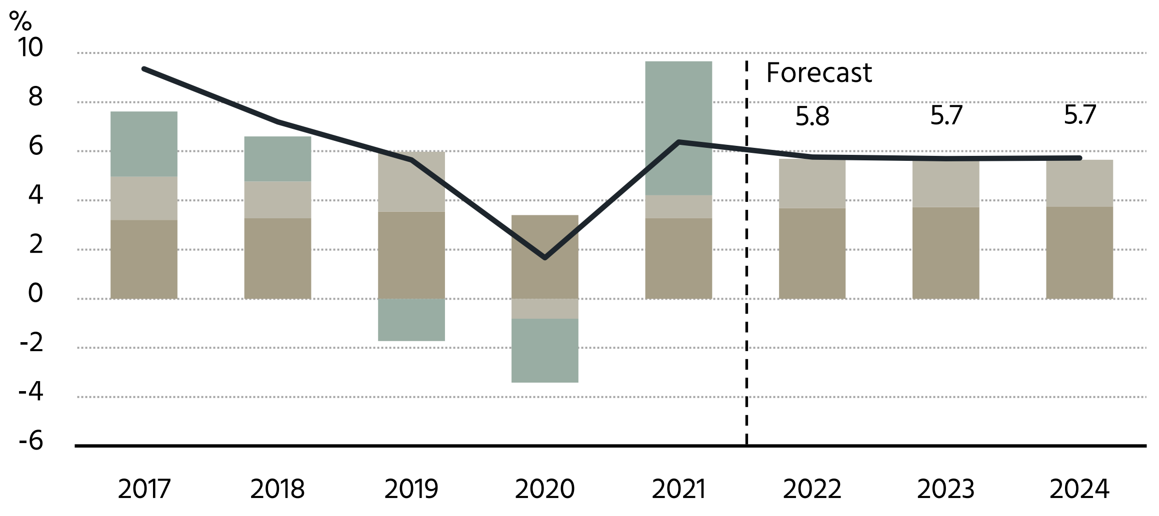
£1.18bn	£27.8m
APAC	EUROPEAN
97.7% OF OVERSEAS INVESTMENT	2.3% OF OVERSEAS INVESTMENT

OUTLOOK

London office total return and components by sub-region

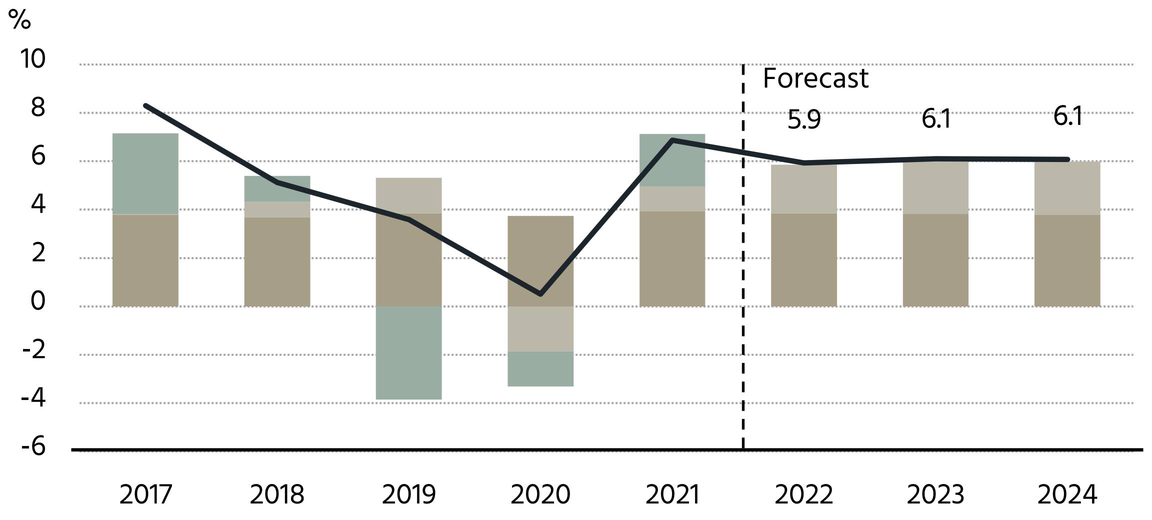
City

Source: Gerald Eve, MSCI



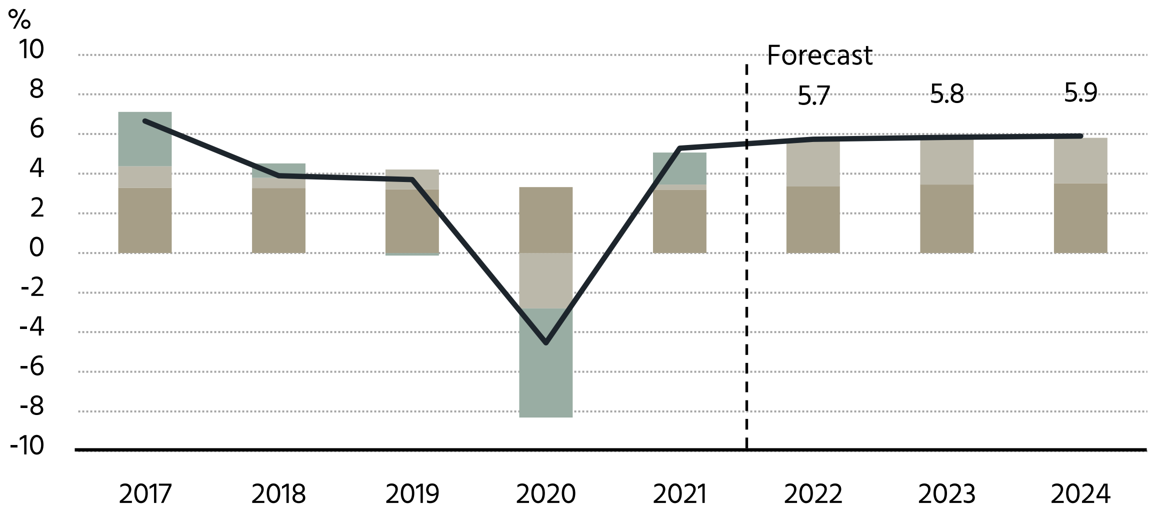
Midtown

Source: Gerald Eve, MSCI



West End

Source: Gerald Eve, MSCI



Income return | Market rental growth | Equivalent yield impact | Total return

The economic backdrop and current political uncertainty in the UK points to a softening of sentiment in the lettings market over the summer months. The bottleneck of occupiers who paused on lease decisions during covid have been enacting office strategies, and much of this has fed through into the market over the last four quarters. Given the low availability of Grade A space, occupiers are now acting when appropriate stock is available. This will arguably translate into an acute “lag-then-spike” demand cycle over the coming quarters while the outlook for the economy remains subdued.

The investment market is likely to see a similar lull, with the cost of capital rising and eroding existing yield spreads. Yields are set to broadly remain flat on aggregate over the year, with the yield compression that occurred in H1 to be reversed in H2, and this is reflected in the forecasts with minimal annual equivalent yield impact. Market rental growth will feature at the higher-quality end of the market, and we have seen a portion of it come through this quarter. However, Grade B and below rents will stagnate or fall as the market becomes ever more polarised.

The shift in yields and debt costs will influence value-add investment stock more acutely in the short term. Rising construction costs associated with the capex needed for these acquisitions will make investors more diligent on pricing and future business plans, seeking discounts where possible. We expect this to shift yields outward for this portion of the market. A step change in the rental profile, reflecting the switch from Grade B to Grade A, is also needed on completion to make the investment business plan viable over the hold period.

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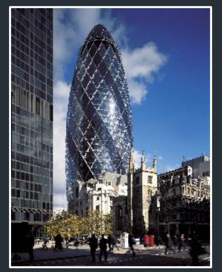
GERALD EVE IN THE MARKET

Ilona Rose House, 113-119 Charing Cross Road
Acting on behalf of Soho Estates, Gerald Eve advised on the leasing of floors 5 & 6 totalling 29,500 sq ft to Skyscanner.

For any further information please contact **Rhodri Phillips.**



The Gherkin, 30 St Mary Axe
Acting on behalf of Swiss RE, Gerald Eve advised on the leasing of level 14, totalling 18,610 sq ft to Kirkland and Ellis.

For any further information, please contact **Fergus Jagger** or **Mark Lethbridge**.

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