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# LONDON MARKETS

London office property
performance and key themes

May 2023

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# LONDON OFFICE MARKET SUMMARY

Occupier take-up was down 19% to 2.4m sq ft in Q1, the lowest since Q2 2021 and 15% below the 5-year quarterly average.

Headline Grade A rents were unchanged in Q1. Market conditions are generally unsupportive of positive rental growth this year given below average occupier demand and elevated development pipeline. However upward pressure is expected in submarkets where Grade A is especially thin.

Availability increased to 8.6% in Q1, up 0.4%-pts on the previous quarter. This increase was due to the addition of development completions delayed from last year and the addition of tenant-controlled space, some of which was originally let relatively recently.

An estimated 1.3 million sq ft of new space completed in Q1 across six schemes. There is a further 7.4 million sq ft expected to complete in 2023, around 4m sq ft of which is unlet and poses a potential short-term supply risk.

A review of London office energy performance certificate ratings highlights the scale of the challenge facing landlords to align to MEES deadlines. There are a large number of offices at risk of being stranded without significant capital expenditure to bring them up to scratch.

London office investment in Q1 was just under £1.7bn. This reflects a more than two-fold increase on the previous quarter, however, Q1 volumes were still 40% below the 5-year quarterly average. Joint venture acquisitions were commonplace this quarter as investors looked to spread risk and return.

**2.4m sq ft** ▼
Take-up, Q1 2023

**8.6%** ▲
Availability rate, Q1 2023

**£1.7bn** ▲
Investment volume, Q1 2023

**45%**
Non-compliant office stock, 2027 MEES deadline

# THE LONDON ECONOMY

## GVA

| | 2022 | 2023 | 2024 |
|---|---|---|---|
| London | 5.5% | 0.5% | 1.7% |
| UK excl. London | 3.6% | -0.8% | 1.5% |

## ILO UNEMPLOYMENT RATE

| | 2022 | 2023 | 2024 |
|---|---|---|---|
| London | 4.5% | 4.8% | 4.9% |

## WORKPLACE-BASED EMPLOYMENT GROWTH

| | 2022 | 2023 | 2024 |
|---|---|---|---|
| Office | 1.7% | -0.4% | 0.8% |

Source: Oxford Economics

## LONDON FLASH PMI MARCH 2023

**55.1 ▲**

**Business Activity Index**

London's third consecutive monthly increase, underpinned by a rebound in client confidence and improved demand.

**58.6 ▲**

**New Business Index**

Growth of new business accelerates to 12-month high as firms report new projects and increased demand from overseas markets.

**69.6 ▼**

**Future Activity Index**

Fractional fall in March but panellists noted that new products and technology will support positive growth.

**51.0 ▲**

**Employment Index**

Slight monthly uptick as some firms reported an increase in staff capacity to meet higher demand, while others cited cost-cutting measures.

Source: IHS Markit
Arrow indicates monthly change

Recent data show an uptick in activity in the early stages of this year. Business activity recorded a third consecutive month of growth, as a rebound in client demand, particularly overseas, placed future order books in a healthier position.

On the back of this, expected GVA growth has been upgraded to 0.5% for the year and is expected to outpace the UK overall.

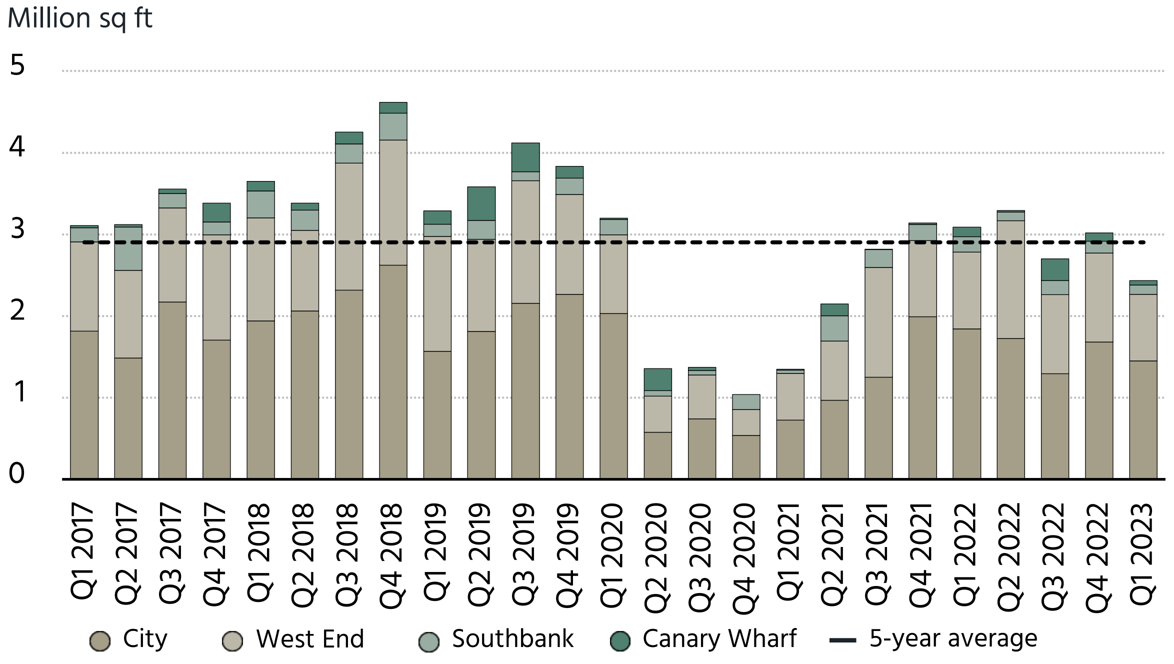
Unemployment is expected to rise but Oxford Economics's forecasts for 2023 have recently been downgraded from 5.2% to 4.8%. Job losses will be more isolated to sectors facing stronger economic headwinds, such as consumer-facing and manufacturing sectors.

Office-employment is forecast to fall marginally, although many firms are still reporting skills shortages. Job creation slipped slightly from the previous month but remained in positive territory.

# DEMAND

## London office quarterly take-up by submarket

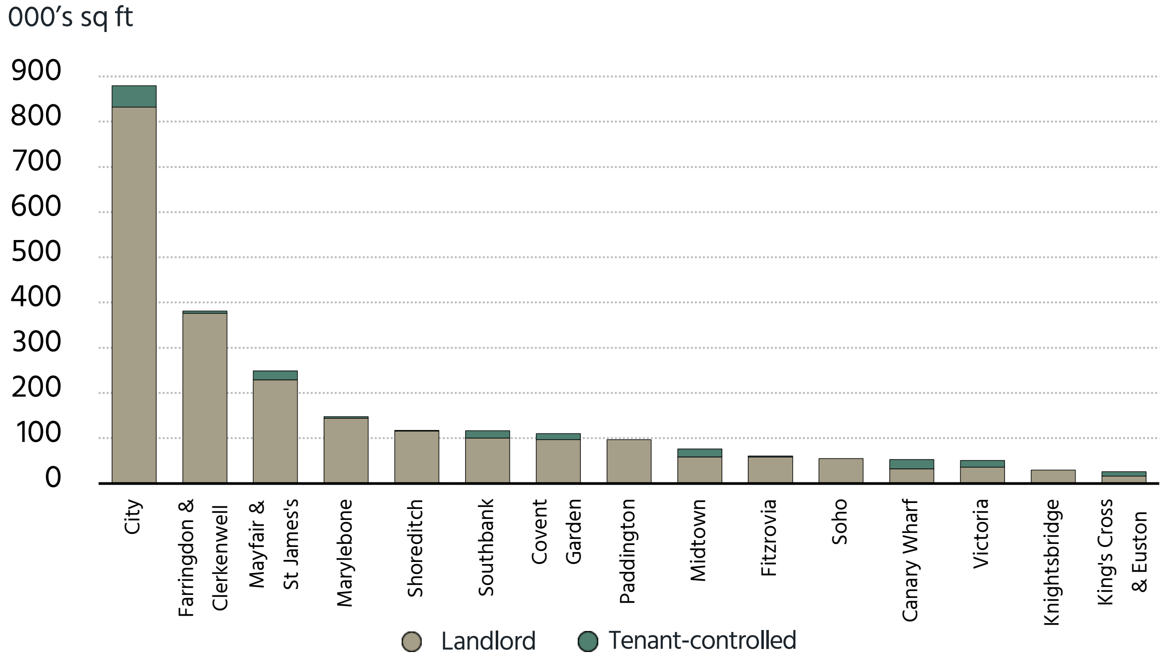
Source: Gerald Eve




Occupier take-up was just over 2.4m sq ft in Q1 2023, the lowest since Q2 2021. This reflects a fall of 19% on Q4 and was 16% below the 5-year quarterly average. Macroeconomic headwinds weighed on occupier activity, with ongoing high inflation and rising interest rates dampening business activity. This was reflected in a notable slowdown in large commitments over 50,000 sq ft, with only five lettings signed for a total of 620,000 sq ft. This marks the lowest count and volume of deals in this bracket since Q2 2021.

## Take-up by submarket and source of letting, Q1 2023

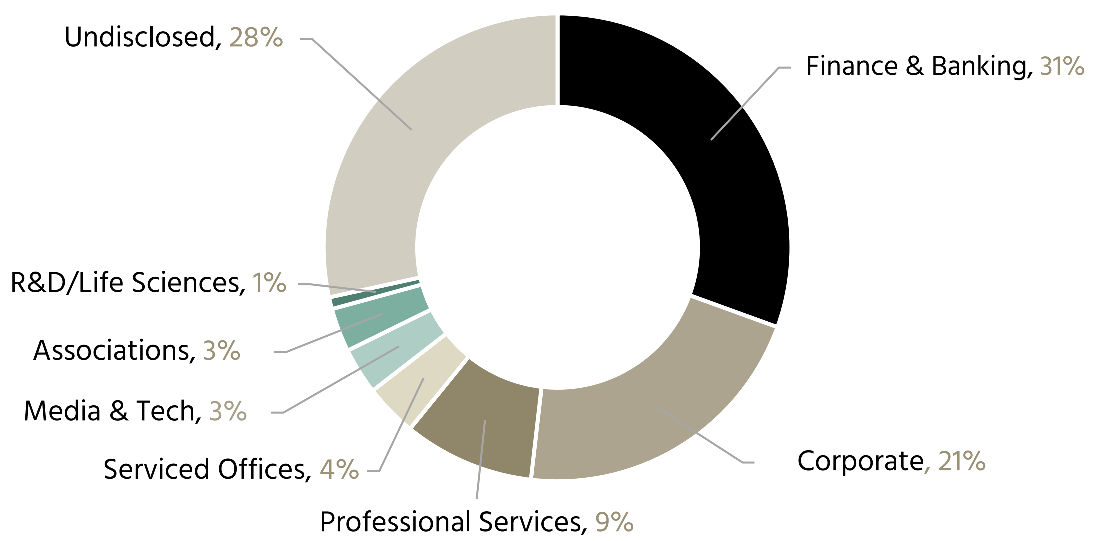
Source: Gerald Eve




By submarket, occupier activity was strongest in the City with just under 0.9m sq ft of take-up. Standard Chartered's 202,000 sq ft letting at 1 Basinghall Avenue was the largest City deal of the quarter. Take-up in Farringdon & Clerkenwell totalled 380,000 sq ft and TikTok's pre-let at 150 Aldersgate meant that Q1 was the strongest quarter for the submarket since Q4 2018. Robust demand in both Mayfair and St James' and Marylebone was also driven by sizeable pre-let activity. These lettings collectively contributed to just over half of overall demand across both submarkets.

## Take-up by business sector, Q1 2023

Source: Gerald Eve



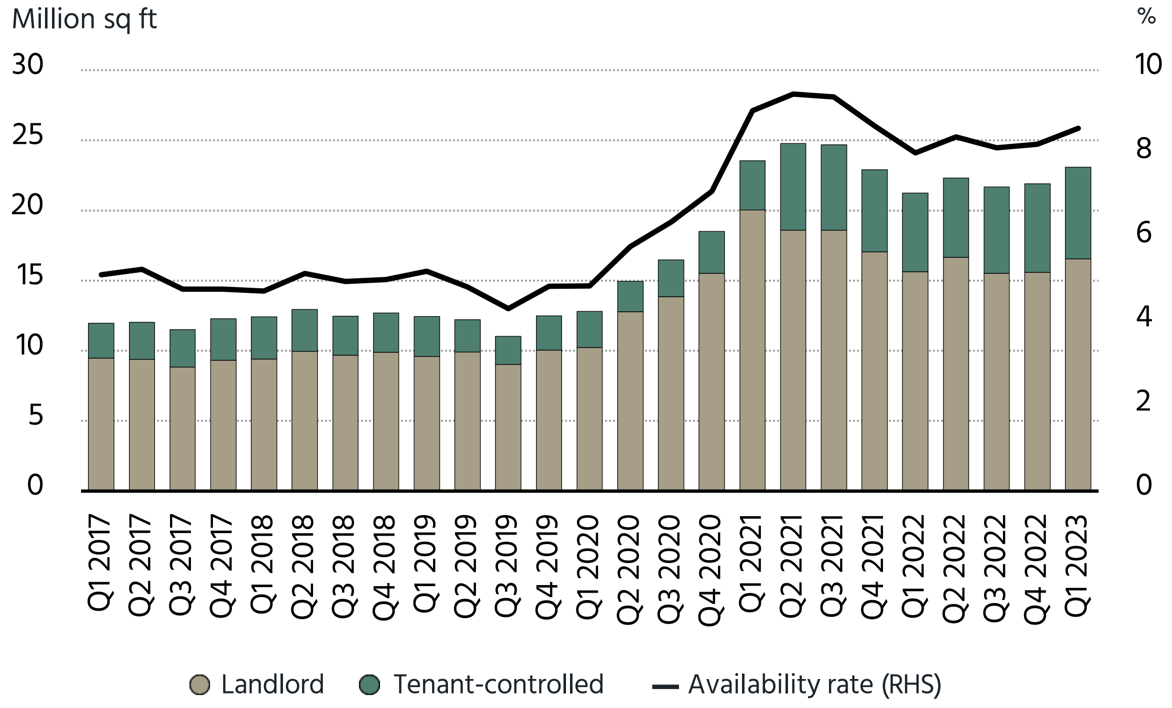

Finance & banking was the most active occupier sector in Q1. The sector made up just under a third of leasing activity, underpinned by robust activity from insurance and investment management firms. Corporates followed with a fifth of activity, boosted by a handful of lettings above 20,000 sq ft. Activity from media & tech firms remained subdued, continuing the slowdown from the previous quarter and reflects the lowest volume of demand for the sector since Q2 2020. Professional services activity was particularly muted, making up only 9% of total demand.

# LONDON OFFICE RENTS AND INCENTIVES, Q1 2023

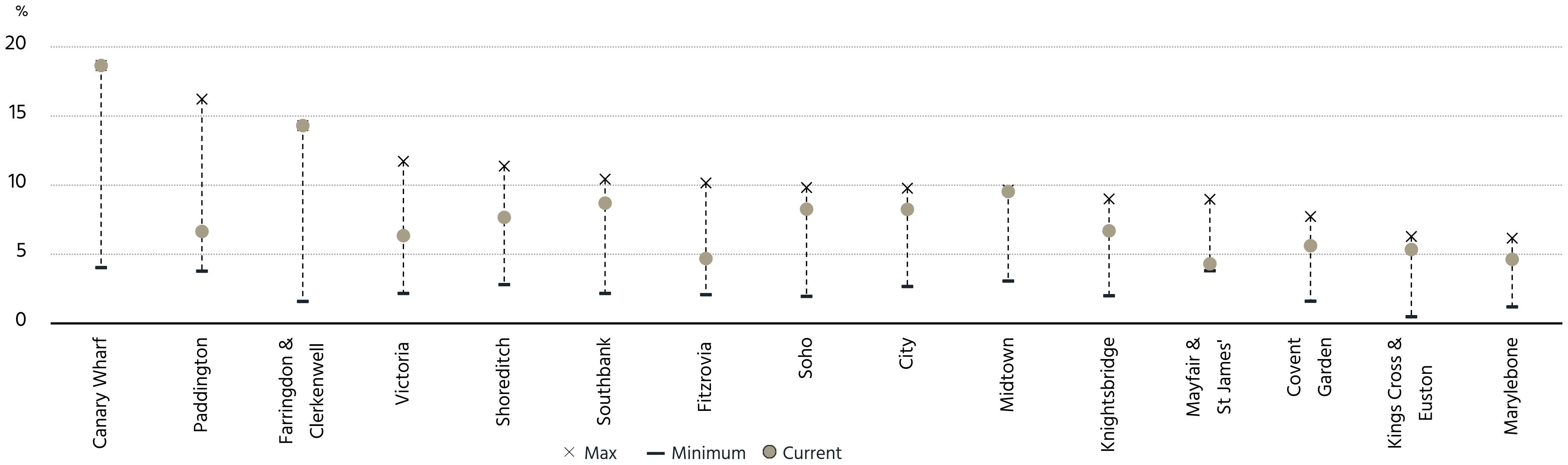

Terms on a typical 10-year lease on a mid-level floor with no terrace

# AVAILABILITY

**Availability by type of listing and rate**
Source: Gerald Eve




**Availability rate, historical range by submarket, Q1 2013 – Q1 2023**
Source: Gerald Eve




The availability rate increased by 0.4%-pts to 8.6% in Q1. Landlord-controlled availability rose for the second successive quarter as several delayed completions came to market. Office absorption looks set to fall this year as the threat of recession weakens demand and the volume of expected completions is high. In turn, availability rates are likely to remain elevated for the remainder of 2023. Tenant-controlled availability also rose to another record-high volume of 6.5m sq ft in Q1, with large occupiers releasing space to market, particularly in media and tech, and FinTech sectors, some of which only signed up to the space in the last two years.

In media and tech, over 250,000 sq ft was released by Warner Bros., Twitter, and Epic Games. Meanwhile in FinTech, Payment Sense and Cinch have placed just under 100,000 sq ft up for sub-let overall, despite originally pre-letting the respective spaces in Paddington and King's Cross in June 2021. Influenced by the ongoing issues in the banking sector, many banks are conducting space requirement reviews. The UBS and Credit Suisse merger will likely lead to redundant office space as the firms consolidate, as well as HSBC's review of office requirements. Additional release of space from finance occupiers will be one to watch in 2023.

Availability fell in six of our 15 tracked submarkets. Shoreditch and Fitzrovia recorded the largest declines, with falls of 1.3%-pts and 0.9%-pts, respectively. Southbank and Canary Wharf posted the highest rises, increasing by 2.7%-pts and 2.4%-pts, respectively. In both submarkets, completions this quarter drove the increase. In Farringdon & Clerkenwell, availability reached 14.3%, a peak for the market driven by the addition of a handful of large sub-lets. Overall, tenant-controlled space makes up just over a quarter of availability in the submarket, the highest proportion on record.

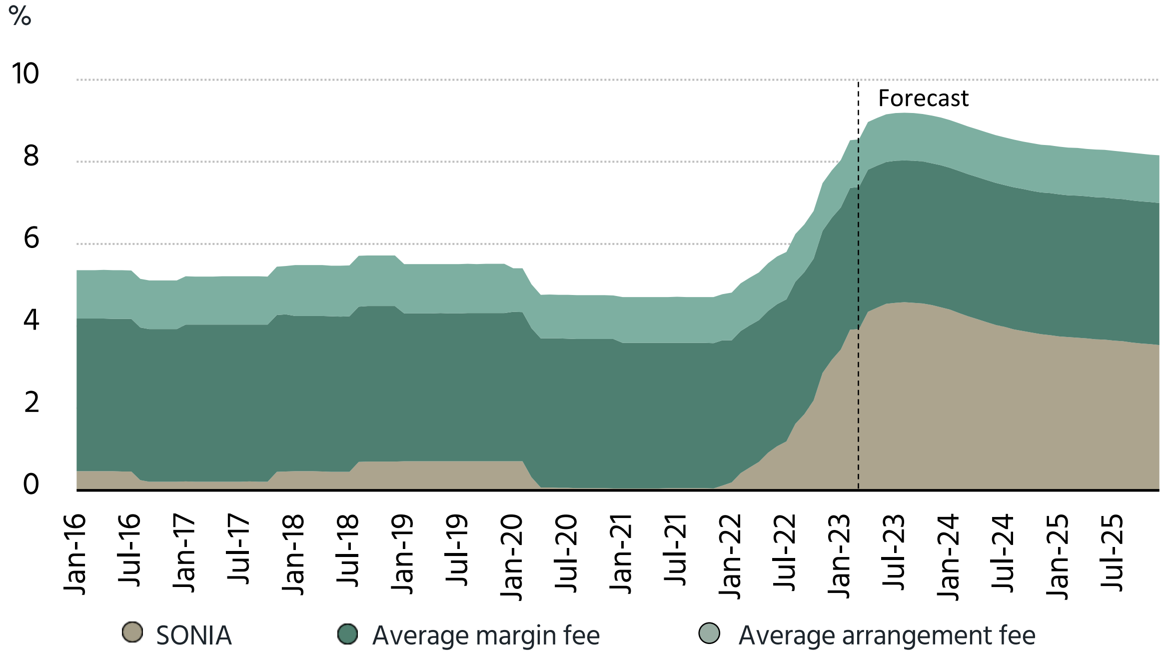
# DEVELOPMENT

**London office development pipeline**

Source: Gerald Eve

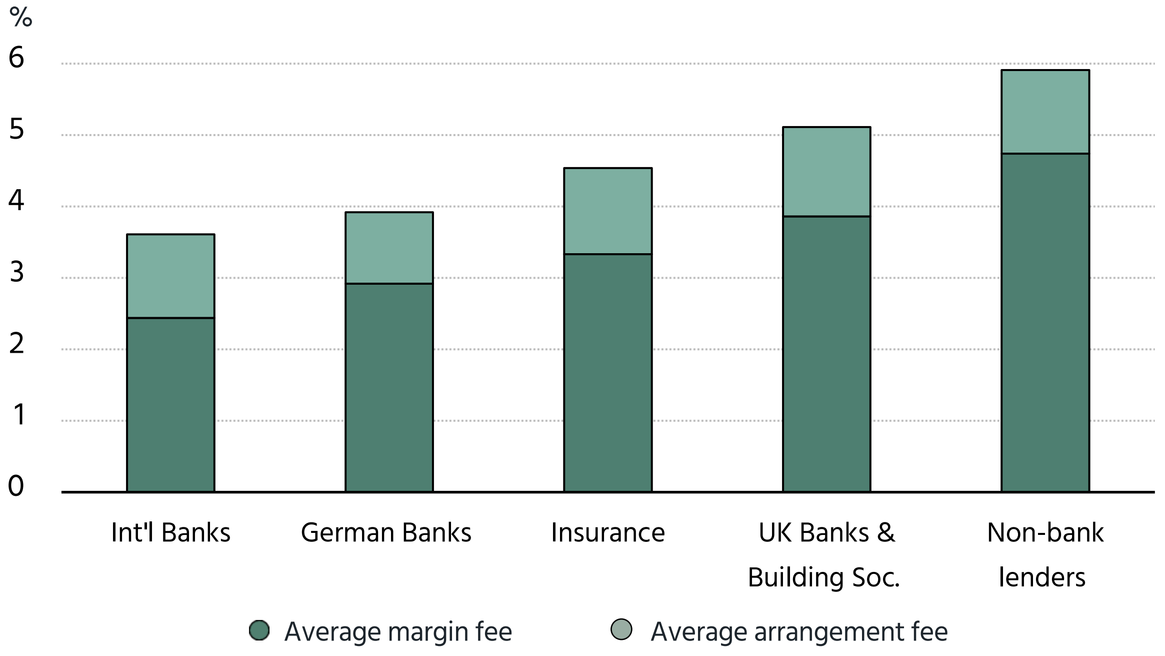

**SONIA forward and average all-in development finance cost**

Source: Bank of England, Bayes Business School, Chatham Financial




**Margin and arrangement fee by type of lender, H1 2022**

Source: Bayes Business School




Just under 1.3m sq ft completed in Q1 across six schemes. Canary Wharf and Southbank recorded completions of 415,000 sq ft and 362,500 sq ft, respectively. The remaining pipeline for 2023 stands at 7.4m sq ft, with the majority of this expected to complete in H1 2023. Positively, 3.1m sq ft of this year's pipeline is pre-let (42%), while 4.3m sq ft remains available. This available space poses a risk for increased availability in the near term, with Southbank a perfect example. The completion of Arbor Yards and The Forge brought 320,000 sq ft to market and pushed up availability to 8.7%.

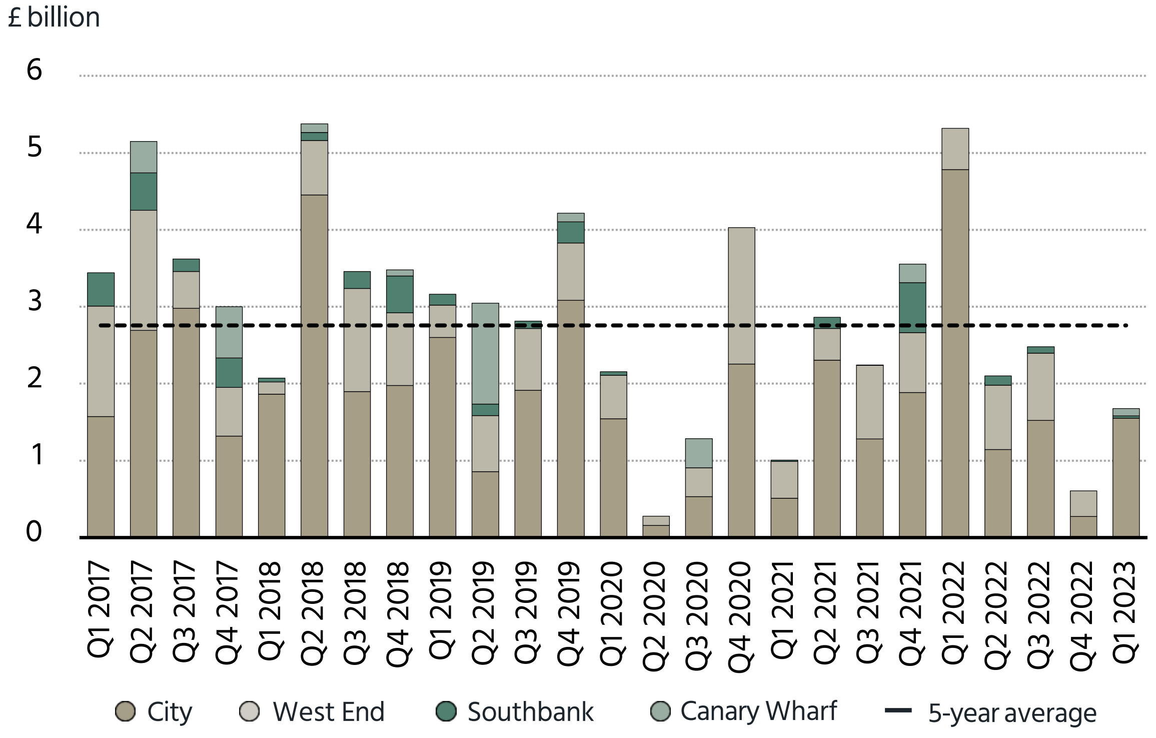
The recent increase in interest rates has severely impacted the cost of development finance. In March 22, the average all-in cost for a fully pre-let office development was around 5.2%, growing substantially to 8.5% in March 23. Based on SONIA forward rates, this will increase to over 9% by mid-Q2 2023. Additionally, further up the risk curve for speculative developments, the margin is roughly 80bps above the pre-let level on average. This will severely dampen the volume of starts over the medium term, given the limited options for financing.

Bayes data show there is wide variation in the cost to access capital, spread across the type of lender. International banks offered the most attractive terms for financing, with a margin and arrangement fee at 3.6%. On the other side of the spectrum, private debt/non-bank lenders fees comprise 5.9%, not including the SONIA base. For developers, accessing financing will be an increasingly selective process, especially in the face of potential tightening credit conditions in the banking sector. Also, cashflows modelled on previous debt assumptions and overall costing will need to be reassessed.

# INVESTMENT

### Quarterly investment volume by broad market

Sources: Real Capital Analytics




Investment market activity showed an improvement in Q1 with just under £1.7bn invested across nine transactions. Positively, this reflects a more than two-fold increase on the previous quarter, however, volumes were still 40% below the 5-year quarterly average. The City accounted for almost all activity, with £1.5bn transacted, making up over 90% of inward flows. The largest acquisition of the quarter was German-based investor MEAG's purchase of One Fen Court for an estimated £640m. This quarter marked the first transaction in Canary Wharf in over a year, with 17 Columbus Courtyard purchased by GIC and Oaktree.

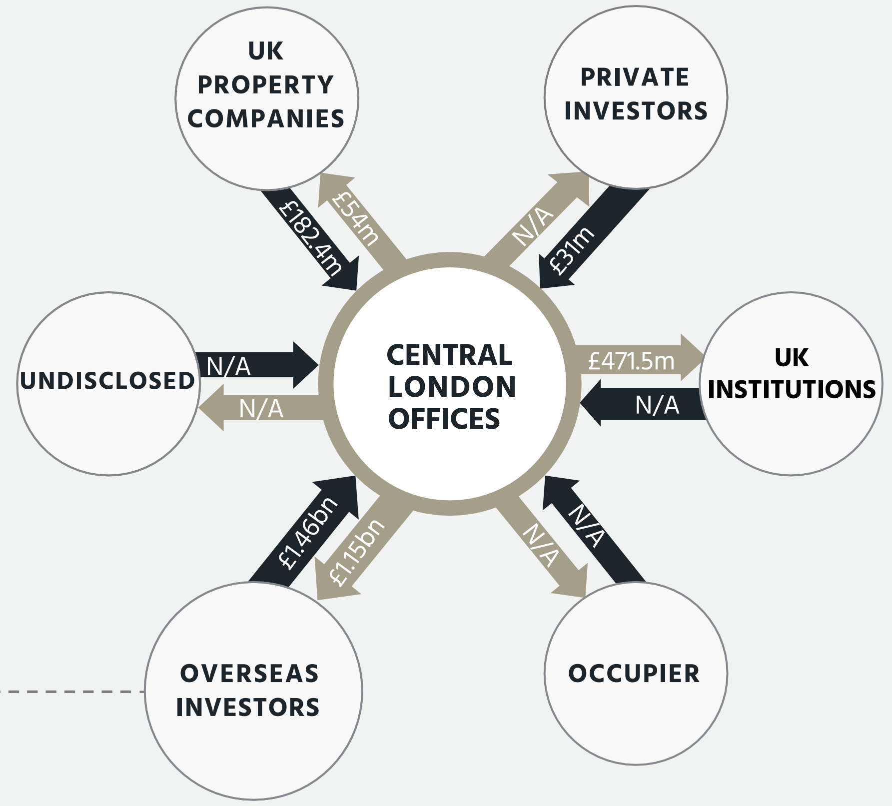
Overseas investors were particularly active this quarter, making purchases totalling just under £1.5bn. Overall, APAC investors made £756mn of acquisitions, representing around half of the overall overseas investor purchase volume. This sub-domicile group was also a common denominator in joint venture acquisitions this quarter, with four out of nine acquisitions made through JVs with an APAC investment partner, totalling £442m.

Joint venture purchases could become a common theme this year as investors seek to spread risk and mitigate the steep rise in debt costs. Some investors will have locked in comparatively favourable rates on credit facilities or have relatively lower central bank rates in their domestic markets. Consequently, these investors are more sheltered against the ramp up in costs of accessing and servicing debt, especially as global credit conditions tighten.

Despite a deceleration in capital value declines and outward yield shift, the spread between current yields and the risk-free rate (10-year gov't bond) remains extremely narrow in an historical context. The average spread over the 10-year for City and West End offices in 2019 was 485bps and 390bps, respectively. Even now that bond yields have stabilised after the mini-budget, the average relative spreads now sit at 250bps and 120bps. This reduced spread will dissuade investors over the next year, with lowered competition for assets as well as ongoing upward pressure on yields.

### CENTRAL LONDON OFFICE CAPITAL FLOWS, Q1 2023

Source: Gerald Eve, Property Data




#### INVESTMENT VOLUME BY INVESTOR SUB-DOMICILE

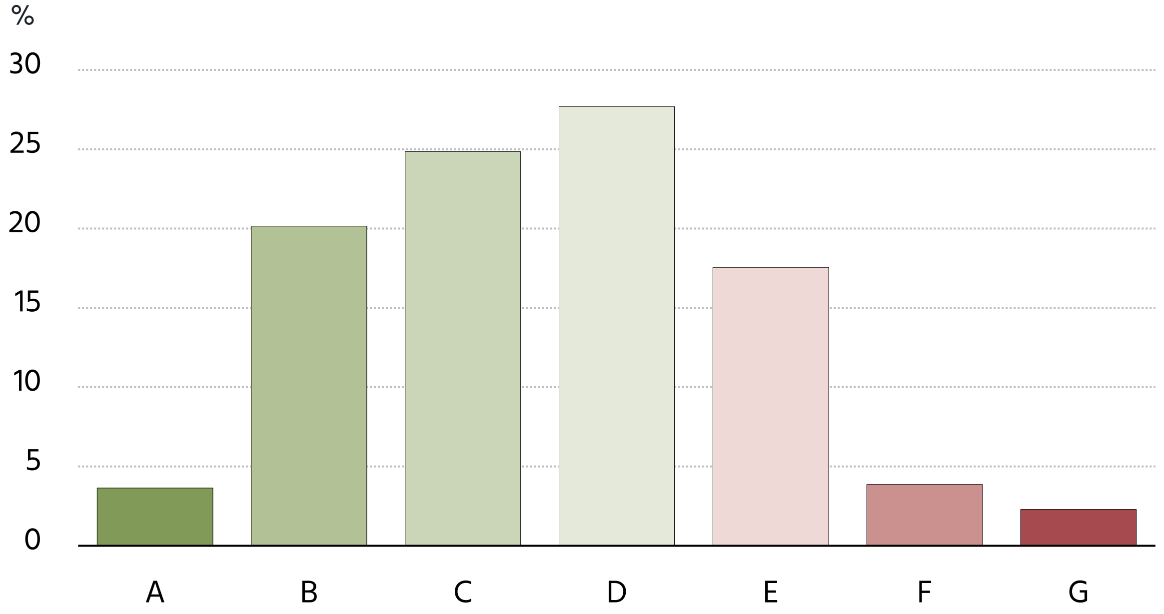
| £755.8M APAC | £640m GERMAN | £47.3m NORTH AMERICA | £20.5m EUROPEAN |
|---|---|---|---|
| 45.1% OF OVERSEAS INVESTMENT | 38.2% OF OVERSEAS INVESTMENT | 2.8% OF OVERSEAS INVESTMENT | 1.2% OF OVERSEAS INVESTMENT |

# ENERGY PERFORMANCE OF LONDON OFFICES

Click here to read more on EPC uprating

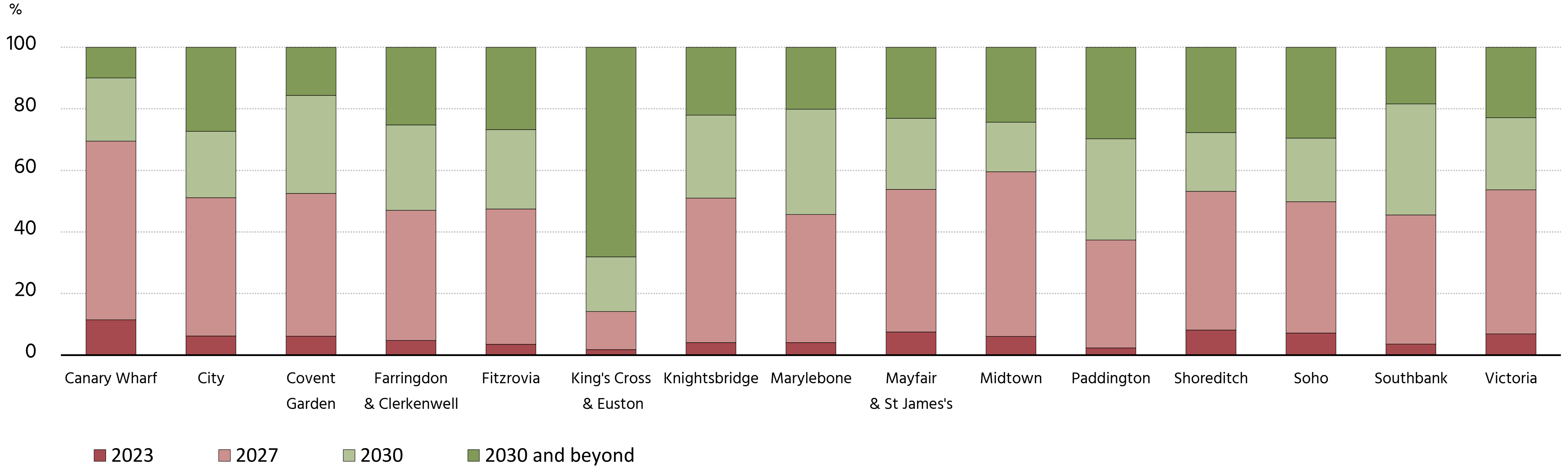
**London offices, proportion of floorspace by EPC grade**

Source: Gerald Eve, DLUHC




**London submarkets, proportion of floorspace by MEES deadline dates**

Source: Gerald Eve, DLUHC




London office energy performance certificate ratings show there is a large challenge facing landlords regarding upcoming MEES deadlines. Just over 6% of overall stock is graded F&G, which means these buildings are no longer lettable under the current regulatory guidelines, notwithstanding exemptions the landlord may have received. The 2027 deadline poses a starker concern, as just under half of all stock falls under the minimum EPC C rating. By 2030, a minimum B rating will be required and just over 75% of stock is below this threshold. Landlords will need to ensure their properties are compliant or risk facing fines for breaches.

Occupiers have voted with their feet for sustainable offices, and most upcoming developments are targeting EPC A ratings. The skew towards higher EPC ratings is apparent in submarkets where recent development has been particularly active, such as King's Cross, the City and Paddington. These submarkets rank among the best performers when it comes to EPC ratings. However, submarkets with older stock and poorer EPC ratings pose more obsolescence risk. These include submarkets like Canary Wharf, Midtown and Mayfair & St James's where over half of stock falls under the minimum EPC C for the 2027 deadline.

There is a real risk that many offices could ultimately become obsolete. Both capital values and income are at risk for offices which are not compliant. Despite the recent deceleration of the outward yield shift for London offices, poor EPC performing buildings pose residual risk for an ongoing rise in yields. This is due to investor appetite moving away from these assets and the capital expenditure required and assumed on acquisition. We expect secondary offices with low EPC ratings to face further valuation falls, as investors seek price compensation for required capex and any risk to income.

# LONDON OFFICE CONTACTS

## Agency & Investment

**Lloyd Davies**
**Partner**
Tel. +44 (0)20 7333 6242
Mobile +44 (0)7767 311254
ldavies@geraldeve.com

**Fergus Jagger**
**Partner**
Tel. +44 (0)20 7653 6831
Mobile +44 (0)7787 558756
fjagger@geraldeve.com

**Rhodri Phillips**
**Partner**
Tel. +44 (0)20 3486 3451
Mobile +44 (0)7768 615296
rphillips@geraldeve.com

**Patrick Ryan**
**Partner**
Tel. +44 (0)20 7333 6368
Mobile +44 (0)7792 078397
pryan@geraldeve.com

## Lease consultancy

**Tony Guthrie**
**Partner**
Tel. +44 (0)20 3486 3456
Mobile +44 (0)7717 225 600
tguthrie@geraldeve.com

**Jenny Rodericks**
**Partner**
Tel. +44 (0)20 7653 6857
Mobile +44 (0)7775 697645
jrodericks@geraldeve.com

## Planning and development

**Lisa Webb**
**Partner**
Tel. +44 (0)20 7333 6225
Mobile +44 (0)7747 607309
lwebb@geraldeve.com

## Research

**Steve Sharman**
**Partner**
Tel. +44(0)20 7333 6271
Mobile +44 (0)7508 008118
ssharman@geraldeve.com

**Ben Clarke**
**Partner**
Tel. +44(0)20 7333 6288
bclarke@geraldeve.com

**Oli Al-Rehani**
**Associate**
Tel. +44(0)20 7518 7255
Mobile +44 (0)7584 112501
oal-rehani@geraldeve.com

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April 2023


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Q1 2023

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