GERALDEVE

LONDON MARKETS

London office property
performance and key themes

October 2022

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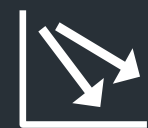
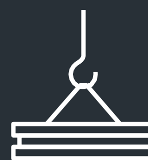
LONDON OFFICE MARKET SUMMARY

London office take-up reached just under 2.7m sq ft in Q3 2022, a fall of 18% when compared with the previous quarter. The uncertainty in the macroeconomic picture over the near term will negatively impact companies' outlook, contributing to a sluggish end to the year for occupier activity.

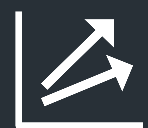
Based on letting evidence this quarter, Grade A rents in three out of the 15 submarkets increased, with Knightsbridge posting the strongest growth. Rent-free incentives also shifted in by three months to 24 and 21 months on a typical 10-year term in Knightsbridge and Soho, respectively.



Availability fell to 8.2% in Q3, a decrease of 0.3-percentage points compared with the previous quarter. Tenant-controlled space reached a peak of 28.1% of overall availability following Barclay's move out of 5 North Colonnade, with over half a million square foot previously occupied, now listed for sub-let.



Forward looking components of the S&P Construction PMI show both future business expectations and new orders decelerated on the month. With financing rates impacted due to recent financial market reaction in the UK, development financing will be less available and come at higher cost.



Rapidly climbing bond yields have materially changed the trajectory of property yields. We estimate that prime yields moved out by at least 25 basis points in Q3 and a further 25bps outward shift is likely by the year-end, putting West End and City yields at 5.2% and 6.0%, respectively.

Nevertheless, unlike the industrial market London office investment volume held up in Q3 and totalled £2.4bn. This was a 20% increase on the £1.9bn transacted in Q2. Just over £1.9bn was acquired by overseas investors, and by domicile, APAC investors were the most active with £1.2bn of inward flows.

2.7m sq ft ▼
Take-up, Q3 2022

8.2% ▼
Availability rate, Q3 2022

£2.4bn ▲
Investment volume, Q3 2022

11% ▲
Construction cost annual growth

THE LONDON ECONOMY

LONDON AND THE REST OF UK GVA

	2021	2022	2023
London	6.7%	4.1%	1.2%
UK excl. London	7.8%	3.3%	0.7%

ILO UNEMPLOYMENT RATE

	2021	2022	2023
London	6.0%	4.7%	4.7%

WORKPLACE-BASED EMPLOYMENT GROWTH

	2021	2022	2023
Office	1.4%	1.9%	0.6%

Source: Oxford Economics

LONDON FLASH PMI SEPTEMBER 2022

52.0 ▼

Business Activity Index

Fall from 54.9 in September, with a slowdown in demand growth and concerns around inflation and interest rates.

51.4 ▼

New Business Index

Weakest growth recorded in 19 months as sales slow due to rising inflation, higher borrowing costs and weaker currency.

63.5 ▼

Future Activity Index

Business confidence down to a 28 months low with firms reporting economic slowdown will lead to a decline in output.

54.9 ▼

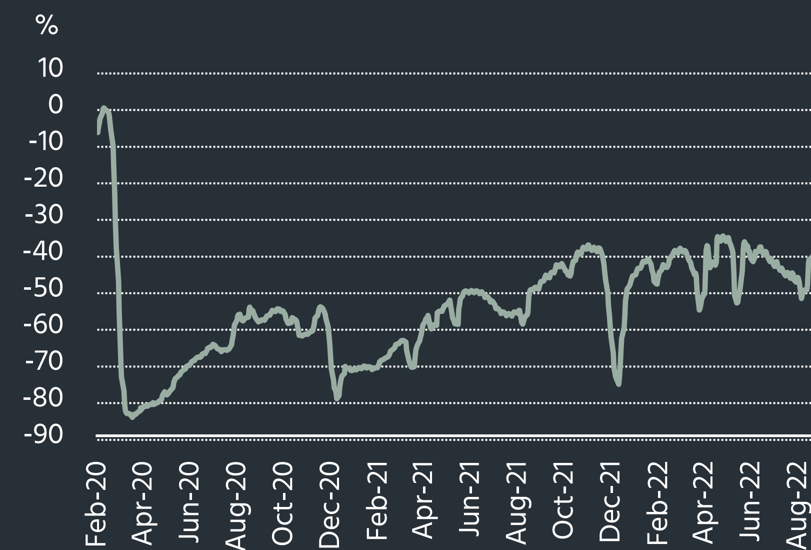
Employment Index

Softest level since March 2021 with contrasting reports from firms. Ability to replace and add staff differs between responses, driven by candidate shortages in some sectors.

Source: IHS Markit
Arrow indicates monthly change

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

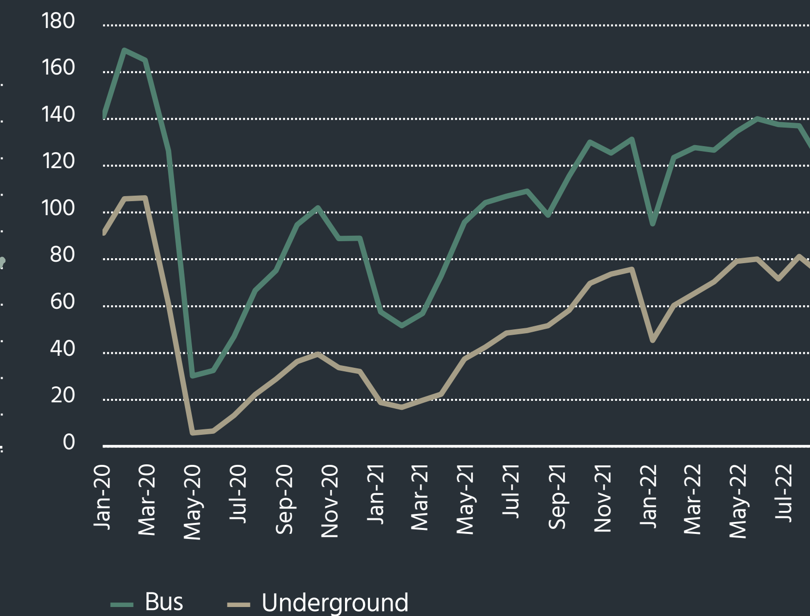
Source: Google mobility data, Gerald Eve



TfL journeys by type of transport

Source: Transport for London

Journeys, millions



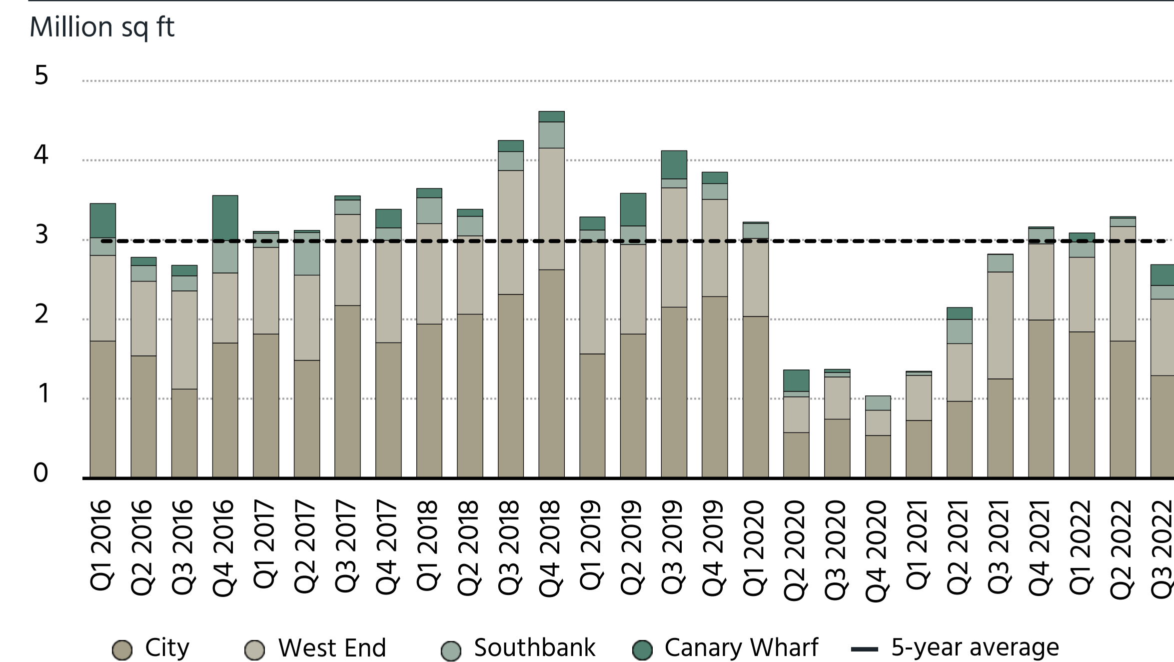
Visits to workplace fell over August driven by school summer holidays, with the average for the month 45% below baseline. There was a strong recovery over September and in the first week in October visits are only 38% below baseline. Despite government support, the October energy cap increase and mounting housing costs will hamper household income. A result of this could be less train journeys, with employees opting to save money by reducing travel expenses.

Recent TfL data show the use of public transport in London followed a similar seasonal pattern over August with Bus and Tube journeys falling by 10% and 9% respectively when compared with the previous month.

DEMAND

London office quarterly take-up by broad market

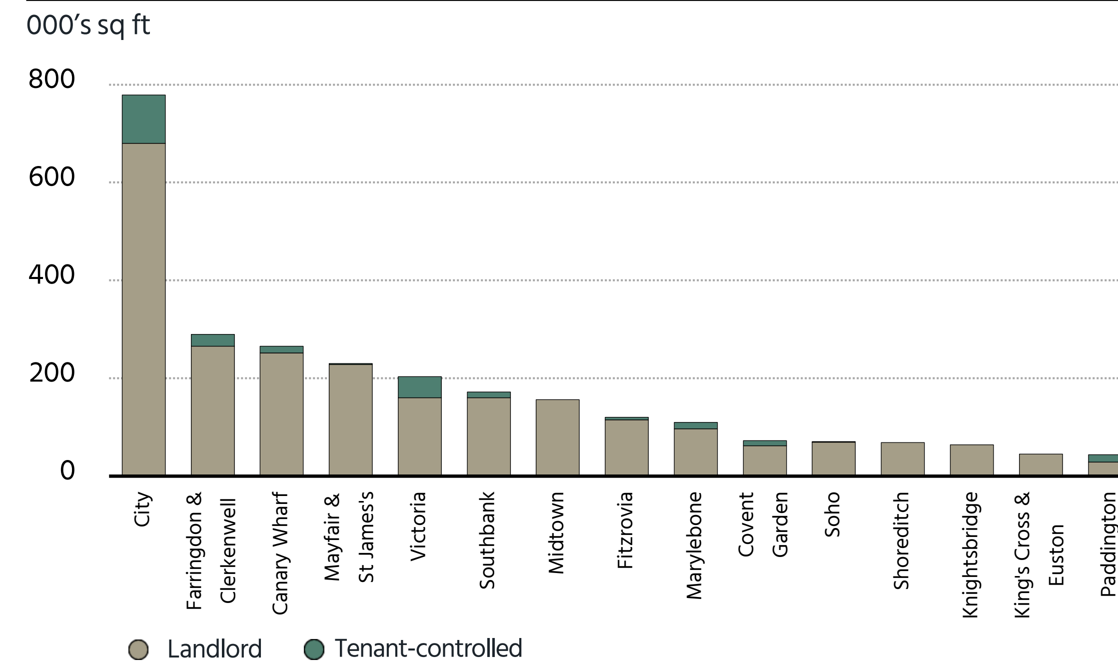
Source: Gerald Eve



London office take-up reached just under 2.7m sq ft in Q3 2022. This was a fall of 18% compared with the previous quarter and 9.8% below the 5-year quarterly average. Occupational activity in the broader City and West End both fell by a quarter and a third respectively. In Southbank and Canary Wharf take-up outpaced Q2 levels, with the latter posting the highest demand outturn since Q2 2020. The softening economic outlook has and will continue to weigh on occupiers, with postponement in leasing decisions likely as inflation pressures and increasing cost of debt negatively impact the short-term outlook for companies.

Take-up by submarket and source of letting, Q3 2022

Source: Gerald Eve



By submarket, occupier activity was greatest in the City with 780,000 sq ft of take-up, with Addleshaw Goddard's 100,000 sq ft at 41 Lothbury the largest letting of the quarter. In Canary Wharf, Citibank took an additional 94,000 sq ft in 40 Bank Street while the current HQ is refurbished. The largest letting in the West End was in Mayfair & St James' with B-Flexion's lease at 1 Berkeley Street which is also currently under refurbishment. Absorption of tenant-controlled space was weak and accounted for 9% of overall demand, with a noticeable fall in activity in secondary and tenant-controlled space over the last two quarters.

> Uncertainty across the political and economic landscape weighed on overall demand in Q3 and there are likely to be some occupiers who seek to delay leasing decisions given the macroeconomic pressures. But demand for premium office space continues to be robust, and prime supply is increasingly tight. This imbalance at the top end of the market has continued to push up headline rents and there are several other large deals under offer that look set to continue this trend.
>
> **Rhodri Phillips, Partner**

Based on letting evidence this quarter, Grade A rents in three out of the 15 submarkets rose. On the back of robust letting activity with just under 50,000 sq ft signed at 1 Hooper's Court in Knightsbridge, rents have increased in the submarket from £90 to £95. Moreover, in Marylebone and Victoria rents increased from £92.50 to £95, and £77 to £79.50 respectively. Rent-frees have moved inward by three months, both in Knightsbridge and Soho, with incentives on a typical 10-year lease now at 24 and 21 months respectively.

LONDON OFFICE RENT AND INCENTIVES, Q3 2022

KING'S CROSS & EUSTON
Grade A
£80.00
Rent Free 18-21 months

FARRINGDON & CLERKENWELL
Grade A
£85.00
Rent Free 22-25 months

FITZROVIA
Grade A
£92.50
Rent Free 21-24 months

MARYLEBONE
Grade A
£95.00
Rent Free 21-24 months

SHOREDITCH
Grade A
£67.50
Rent Free 24-27 months

PADDINGTON
Grade A
£82.50
Rent Free 21-24 months

MIDTOWN
Grade A
£70.00
Rent Free 27 months

SOHO
Grade A
£97.50
Rent Free 21 months

COVENT GARDEN
Grade A
£82.50
Rent Free 24 months

CITY
Grade A
£70.00
Rent Free 27 months

MAYFAIR & ST JAMES'S
Grade A
£130.00
Rent Free 18-21 months

Canary Wharf
Grade A
£47.50
Rent Free 24-27 months

SOUTHBANK
Grade A
£70.00
Rent Free 21 months

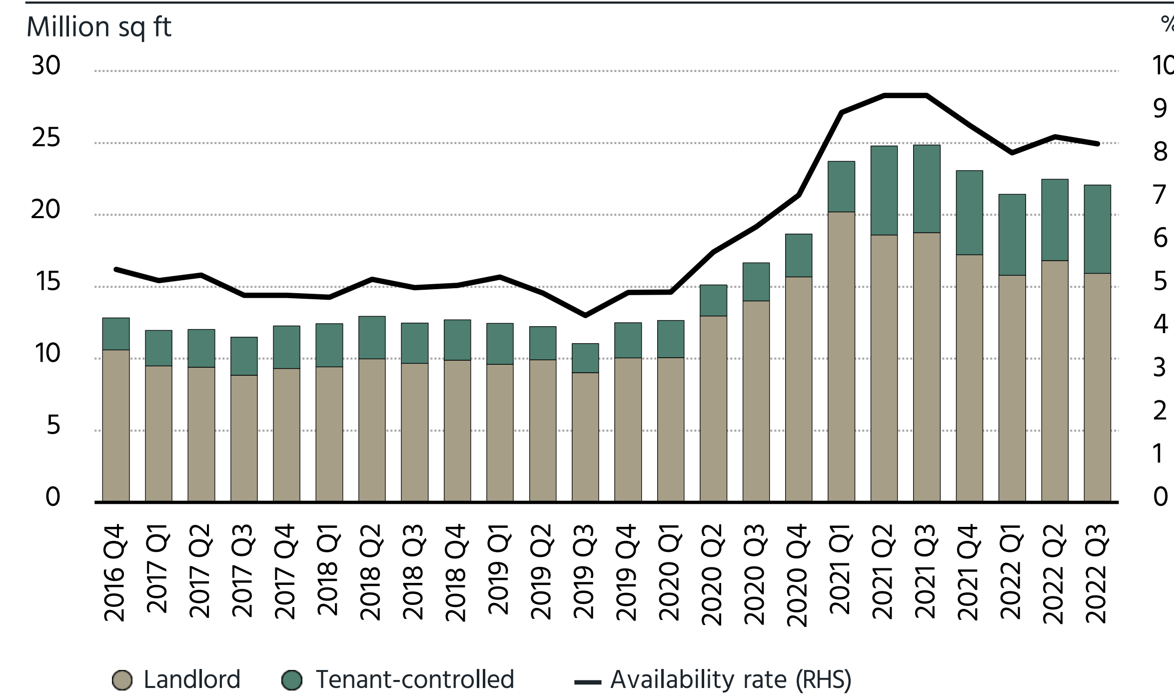
KNIGHTSBRIDGE
Grade A
£95.00
Rent Free 24 months

VICTORIA
Grade A
£79.50
Rent Free 24 months

AVAILABILITY

Availability by type of listing and rate

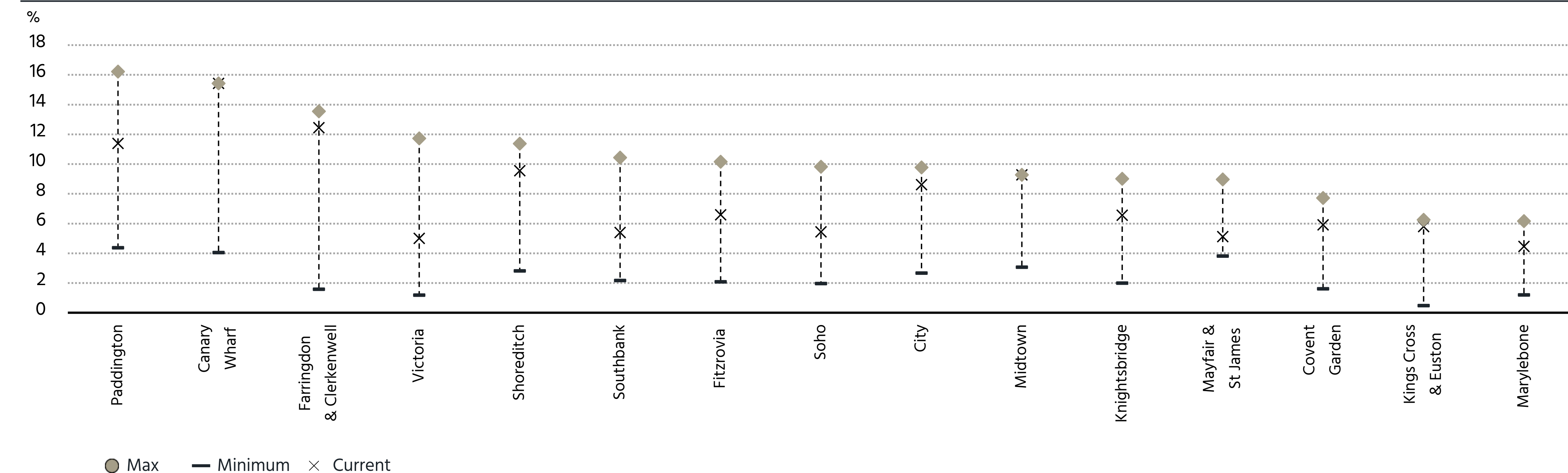
Source: Gerald Eve



The availability rate fell marginally in Q3 to 8.2%, an decrease of 0.3%-pts compared with the previous quarter. Ongoing delays in refurbishments and new schemes means new office space is coming to market in large waves, with many schemes cited for summer delivery are now coming online. This is temporarily upholding available space despite more consistent demand levels over the last four quarters. This quarter's availability figure is skewed upward with Barclays vacating 0.5m sq ft. This is the largest availability on record and largely offset falls in availability across other submarkets.

Availability rate, historical range by submarket, Q1 2013 – Q3 2022

Source: Gerald Eve



The move from Barclays has contributed to a sharp increase in the volume of tenant-controlled space in Canary Wharf, with 62% of all availability within the submarket attributable to sub-let space. Overall, the volume of tenant-controlled space rose by 8.6% to 6.1m sq ft in Q3. Overall, tenant-controlled space now makes up 28.1% of total availability, the highest proportion on record in recent history. The existing excess supply underpinned by ongoing void periods in tenant-controlled and secondary space, will put downward pressure on rents and capital values over the coming months across Grade B quality offices and below.

More positively, across the 15 tracked submarkets, nine reported falls in availability. Knightsbridge and Victoria had the largest declines, with falls of 2.5%-pts and 2.6%-pts to 6.6% and 5.0% respectively, while Southbank availability fell 2.3%-pts from 7.7% to 5.4%. Covent Garden availability reached 5.9%, and is now in line with pre-Covid availability following strong demand over the preceding four quarters. New refurbishments coming to market pushed availability in Midtown, Farringdon & Clerkenwell and Shoreditch up, the latter of which had the largest increase at 1.7%-pts to 9.6%.

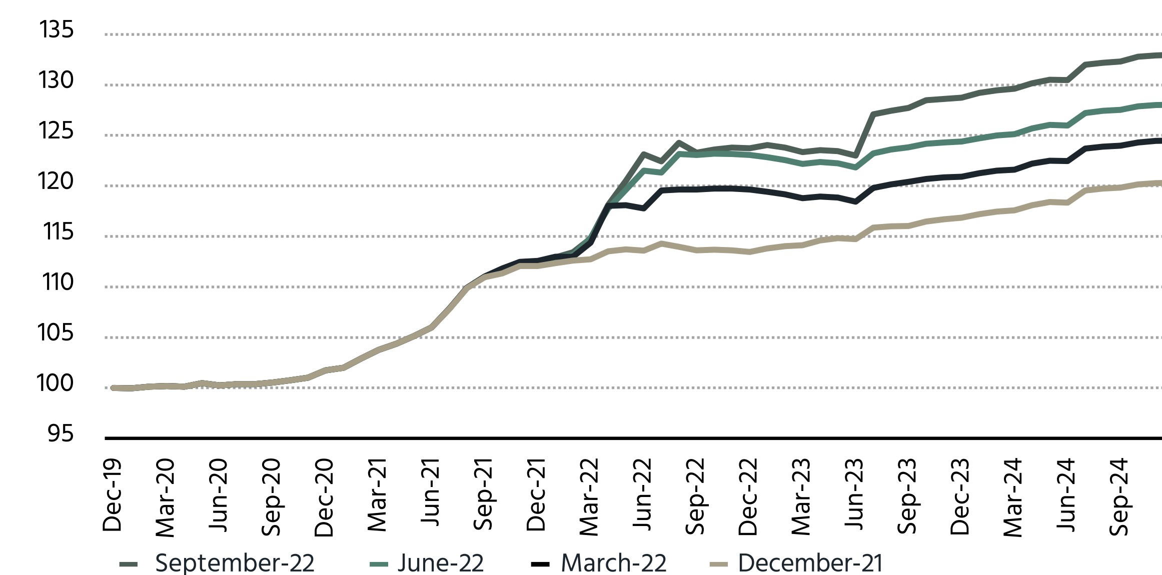
DEVELOPMENT

London office development pipeline

Source: Gerald Eve

BCIS general build cost forecasts

Source: BCIS



With ESG being front and central to occupier demand, combined with the need for extensive building amenities that are both expensive to deliver and can reduce net areas, short term cost cutting solutions in these areas should still be avoided despite the current market headwinds. For those who are able to take a longer-term outlook, financing solutions remain more readily available if used to upgrade buildings in line with future requirements – in particular targeting EPC B prior to the 2030 regulation cut-off – with lender sentiment taking a long-run view through the cycle.

Ben Nichols, Senior Associate

An estimated 530,000 sq ft completed in Q3 across four new developments, the largest of which was the 200,000 sq ft scheme at 33 Charterhouse Street in Farringdon & Clerkenwell. Total completions for 2022 now stand at 1.4m sq ft. Positively, the remaining 2022 pipeline of just under 3.9m sq ft is now 43% pre-let (2.2m sq ft), with several schemes under offer going into Q4. Delays and postponements in delivery means the original 7.7m sq ft of completions estimated for 2022 at the beginning of the year has been trimmed back to 5.2m sq ft, with an estimated 2.5m sq ft spilling over into the 2023 pipeline.

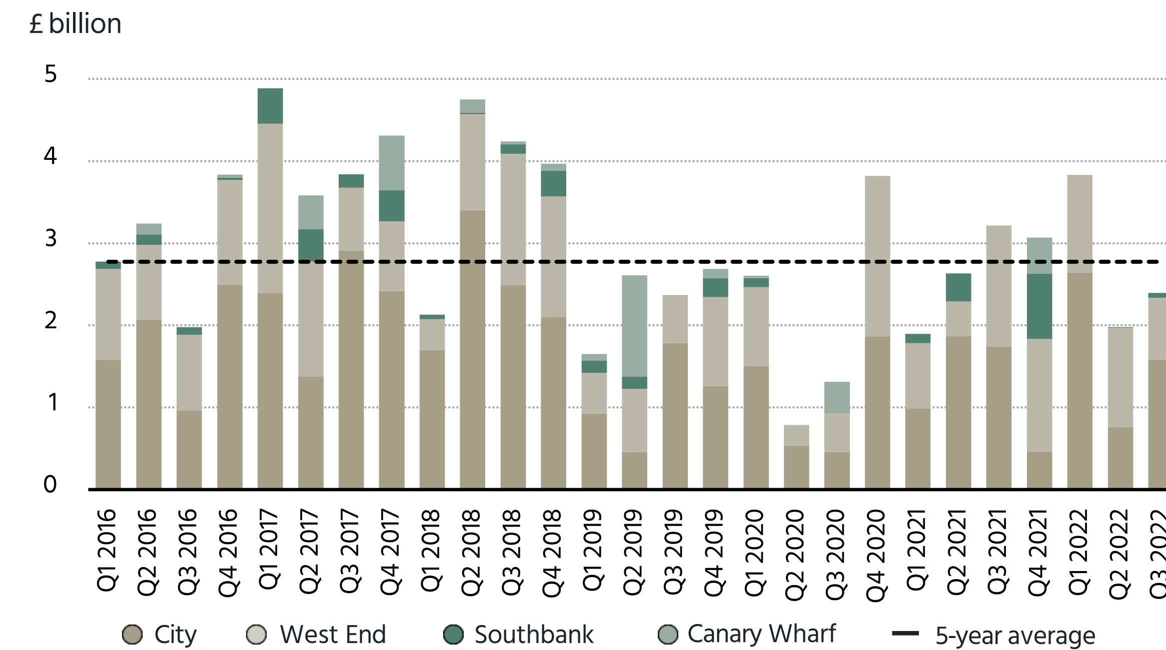
Build cost inflation rose again but at a decelerated pace based on the September 2022 forecast. On average over the next 12 months, costs are expected to be 0.8% higher than anticipated in June, with general build costs now just under 25% higher than they were in December 2019. The forecast data show a 3.3% monthly uplift in July 2023, underpinned by an expectation of a 10% increase in builders wages at the end of H1 2023. The BCIS have revised upward expectations of labour costs across various construction subsectors, with wage increases now more front-loaded, contributing to the sharp upward adjustment.

The S&P Global CIPS Construction PMI for September showed a slight uplift in activity, increasing from 49.2 to 52.3. This reflected an improvement on the supply side, with delivery times down and improving contractor availability. However, amid the worsening economic backdrop and rising interest rates this improvement will be temporary. Forward looking components of the PMI slowed with both future business expectations and new orders decelerating on the month. With financing rates materially impacted on the back of recent financial market turmoil in the UK, there is downside risk to the development market.

INVESTMENT

Quarterly investment volume by broad market

Sources: Gerald Eve, Property Data



Despite the softening economic backdrop, investment activity was robust in London offices, reaching £2.4bn in Q3. This was an improvement of 20% when compared with last quarter, but still 15% below the 5-year quarterly average. Activity in the City led the way with £1.3bn transacted across four deals, the largest of which was Lendlease's acquisition of 21 Moorfields, the new Deutsche Bank HQ , for £809m. Perhaps indicative of what's to come over the near-term, the transacted price reflects a price chip of over £100m compared with LandSec's originally marketed value when the campaign was first brought to market.

In the West End, overall volume was £750m, with Marylebone and Victoria the most active submarkets. Respectively, activity reached £165.5m and £402.8m, with APAC investor Lembaga Tabung Haji's £247.5m acquisition of 33 Horseferry Road the largest of this quarter's transactions in the West End.

Overseas investors continue to drive London office activity with £1.8bn of inward flows over six transactions. APAC investors were the most active by domicile, with half of total investment volume this quarter (£1.2bn) attributable to the group.

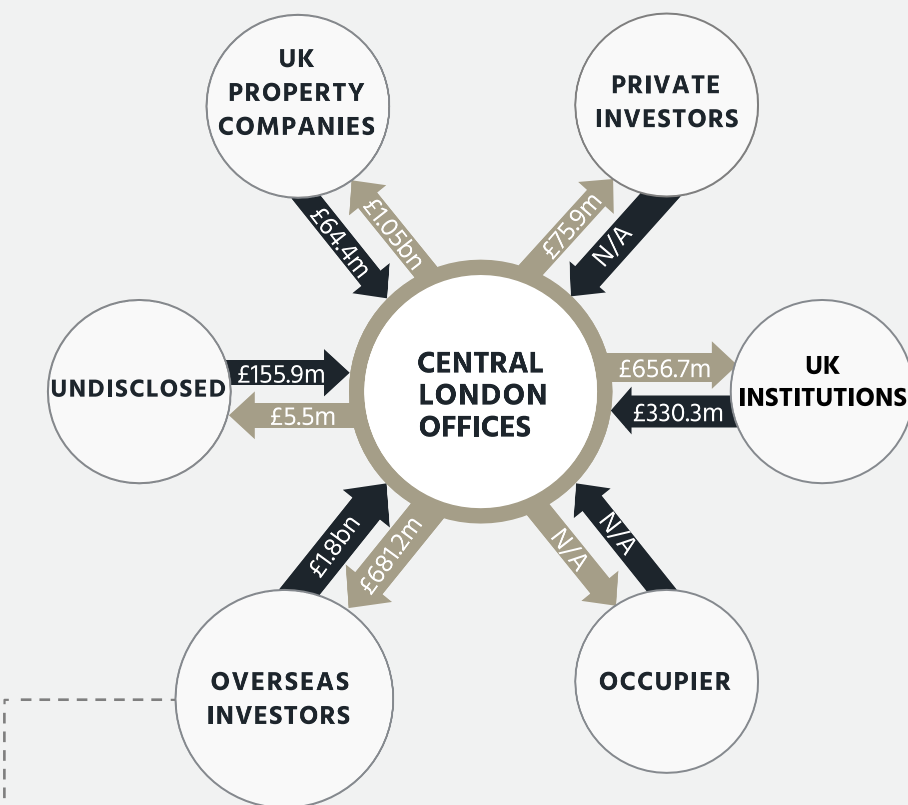
UK-based investors featured heavily on the sell-side, making a total of £1.7bn of disposals. UK prop co's and UK institutions sold just over £1bn and £656.7m of assets respectively in Q3.

The recent devaluation in Sterling, following the government's mini-budget, poses potential buying opportunities for non-sterling denominated funds. Well-capitalised overseas investors which have achieved favourable foreign exchange terms, will be active given the relative devaluation for UK assets.

Investors will need to sell to meet redemption calls and will shift out of IRR driven investments on the expectations that capital values could fall materially over the near to medium term given the outward trajectory for yields. This could shift business plans and expected hold periods as existing vendors could pull sales, as absorbing CapEx costs now and selling at a later date becomes favourable opposed to selling at discount pricing now.

CENTRAL LONDON OFFICE CAPITAL FLOWS, Q3 2022

Source: Gerald Eve, Property Data



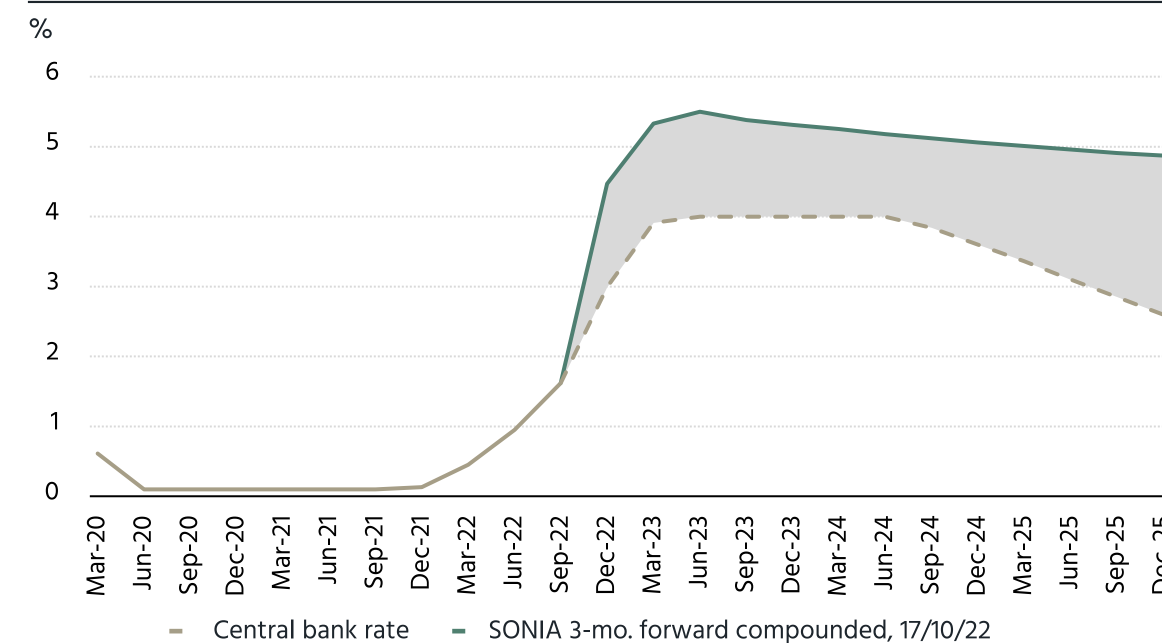
INVESTMENT VOLUME BY INVESTOR SUB-DOMICILE

APAC	GERMAN	NORTH AMERICA	EUROPEAN
£1.22bn	£356.3m	£164.5m	£32.4m
68.7% OF OVERSEAS INVESTMENT	20.1% OF OVERSEAS INVESTMENT	9.3% OF OVERSEAS INVESTMENT	1.8% OF OVERSEAS INVESTMENT

INVESTMENT OUTLOOK

Central bank interest rate forecast vs. SONIA

Sources: Oxford Economics, Chatham Financial



The damaging fiscal stance the government took following the mini-budget has been reversed with a new budget expected at the end of October, notably excluding the unfunded tax cuts. However, scarring in financial markets remains, with government credibility now razor thin and a leadership contest adding to the ongoing uncertainty surrounding the political landscape. Thus will conflate with financial uncertainty until clearer policy direction arises. The reversal improved the outlook for the economy, but inflationary pressures, the trajectory of interest rates, and the likelihood of recession remain strong headwinds.

Forecasts from Oxford Economics show interest rates are expected to reach 4% by June 2023, but expectations in the market point to upside potential for rates, with the forward SONIA curve peaking at 5.5% in the same period. With an interest cover margin of 150bps over SONIA, lending rates will approach 7%, currently higher than prime London office yields.

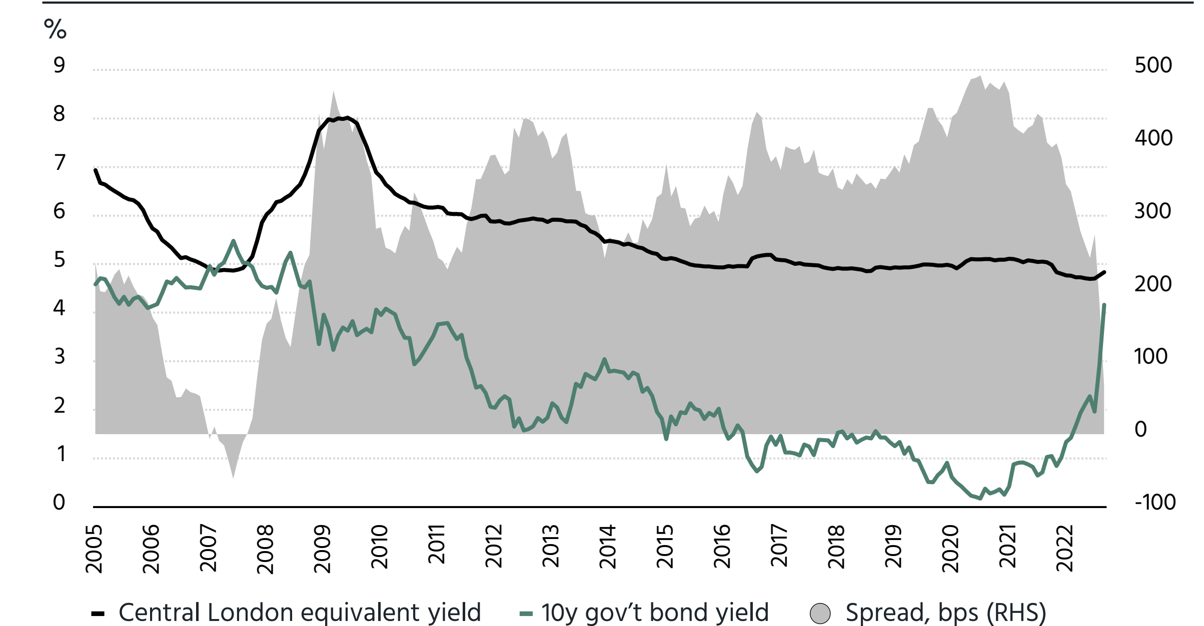
Outward yield shift in the direct market has been significant and further movements are anticipated as investors seek additional compensation over the rising risk-free rate. We expect prime yields moved out by at least 25bps compared with the end of summer, with a further 25bps outward shift anticipated by year end. Despite the recent fall in bond yields the September MSCI show a spread over central London office equivalent yields of just under 70bps, the lowest since November 2007.

The era of cheap and available debt financing has to come to an end in the UK, with interest rates unlikely to return to pre-pandemic levels for the foreseeable future. Higher cost of credit and diminishing availability will give rise to greater transactional friction as financing terms cause purchase withdrawals or repricing over the near term.

Several recent deals have been pulled, with vendor aspirations not achieved. Value-add product will face the brunt of outward yield shift as these conditions contribute to falls in capital value, with discounts sought after to attain attractive risk premia.

Central London offices equivalent yield and spread

Sources: MSCI, Bank of England



Sentiment in the investment market is sensitive, with different pricing aspirations between vendors and purchasers. The economic and political uncertainty has shifted the trajectory for bond and property yields, with inevitable repricing over the near-term. However, there is still a large volume of capital targeting London offices. Long-dated income in Grade A offices and income growth from ESG improvements remain attractive, particularly for overseas investors seeking discounts while sterling is weak. Value-add assets are set for a greater fall in pricing than others, which may also offer investors an opportunity to selectively deploy pent-up capital.

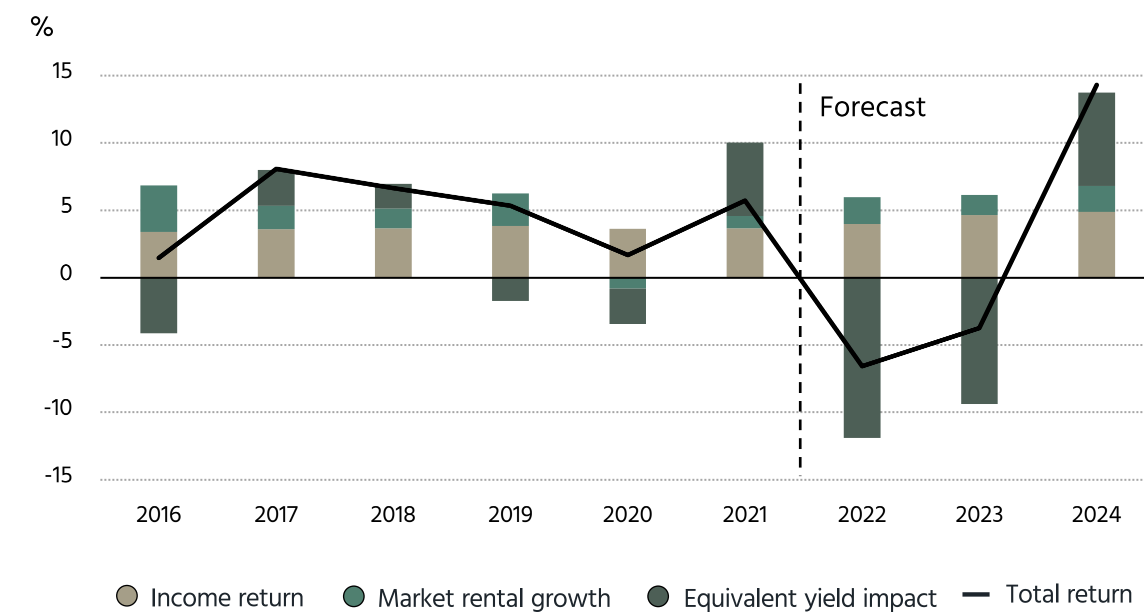
Lloyd Davies, Partner

OUTLOOK

London office total return and components by sub-region

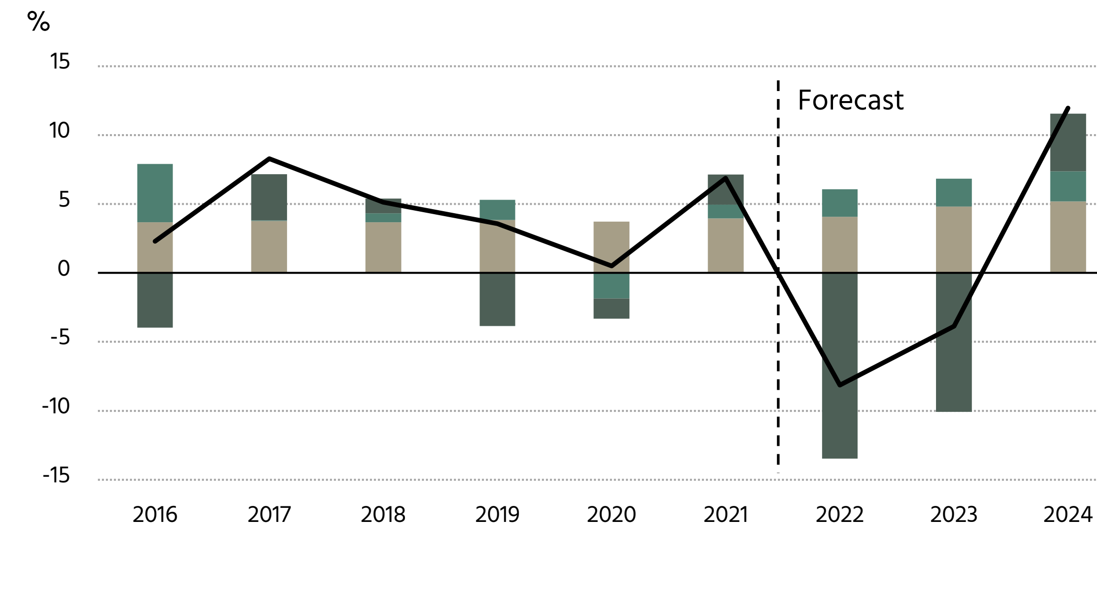
City

Source: Gerald Eve, MSCI



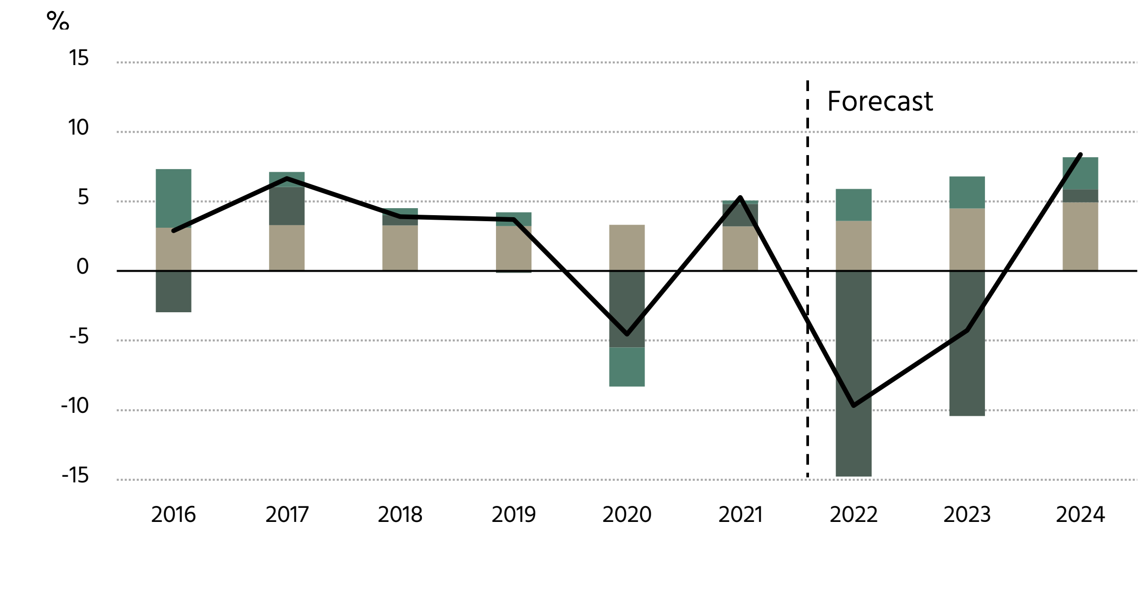
Midtown

Source: Gerald Eve, MSCI



West End

Source: Gerald Eve, MSCI



The currently elevated economic and political uncertainty points to damaged sentiment in both the capital and occupier markets in the near term. The demand and supply imbalance in premium quality space will place upward pressure on rents, contributing to positive market rental growth in the forecasts. However, residual secondary and tenant-controlled space will fall further behind. The new economic conditions will push the dichotomy between Grade A and B even further, and over the coming months we expect a cementation of the best vs the rest.

With the cost of capital far above it's level from even a month ago, yields are expected to move out across all London segments over the remainder of the year and into 2023. Negative yield impact arising from these shifts has contributed to a change in performance outlook for London offices, with negative returns expected across the board in 2023. Backward looking valuation metrics do not reflect the transacted market, but falls in capital values are expected, with forecasts showing a decline ranging between 10-13% across London segments by year end.

The shift in paradigm for premium over the risk free rate in the UK has materially changed the outlook. The trajectory of policy rates and bond yields, means office yields are not expected to move inward until the bank end of 2024, reflecting the shift in monetary policy as the country moves out of the likely recession on the horizon. There is a case to be made that HNWI and foreign investors will continue to purchase at pre-budget yields, but this will be focused in trophy assets in the City and West End, but these will not be reflective of the overall market.

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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 of 9,100 sq ft on Level 7 to Dawn Capital, and 17,300 sq ft on Level 4 to Planet Payment.

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

Warwick Court, Paternoster Square
The City office agency team has recently advised Mitsui Bussan Commodities Ltd on the acquisition of 25,500 sq ft on the 1st floor. The building is highly sustainable and has excellent amenities including a shared rooftop terrace.

For any further information, please contact **Jessica Nutt** or **Mark Lethbridge**.

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