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LONDON MARKETS

London office property
performance and key themes

February 2023

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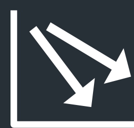
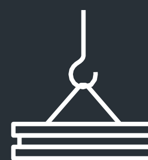
LONDON OFFICE MARKET SUMMARY

London office leasing activity closed out the year out strongly as occupier take-up increased 10% on the quarter in Q4 and totalled 3m sq ft. Take-up over 2022 as a whole was 12.1m sq ft - a significant 28% increase on 2021, but still 17% below the pre-covid five-year average.

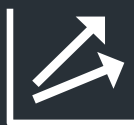
Grade A rents rose in four submarkets this quarter, with strong demand in the City pushing rents from £70 to £75. Additionally Covent Garden, Midtown, and Southbank rents increased. Above average availability in Shoreditch contributed to a downgrade to £65, falling from £72.50 pre-pandemic.



Availability remained stable in Q4, with only a minor change on the previous quarter. This quarter marked a high watermark for tenant-controlled sub-let availability. Estimates show roughly 6.3 million sq ft of "grey space" is on the market, making up a record-high 29% of overall availability.



Multiple delayed deliveries meant annual development completions reached 2.2m sq ft this year, 70% below the original estimate for 2022. A bloated pipeline is anticipated for 2023 with 7.8m sq ft of expected deliveries. Increased development financing costs means starts are likely to be muted in the short term.



The recent outward yield shift in central London offices has led to a sharp correction in values. MSCI's monthly December 2022 data show a quarterly fall of 10% in the capital value index since September's ill-fated mini-budget. We expect office values to bottom out in 2023 before beginning the recovery.

London office investment in Q4 came in at just under £1.6bn, one of the lowest volumes on record barring the covid-lows in Q2 and Q3 2020. The investment market was markedly subdued with investors in wait-and-see mode on the sidelines after the ill-fated mini budget in late September.

3.0m sq ft ▲
Take-up, Q4 2022

8.2% ▲
Availability rate, Q4 2022

£1.6bn ▼
Investment volume, Q4 2022

29% ▲
Tenant-controlled space, % of total

THE LONDON ECONOMY

LONDON AND THE REST OF UK GVA

	2021	2022	2023
London	9.1%	5.5%	-0.1%
UK excl. London	7.8%	4.1%	-0.7%

ILO UNEMPLOYMENT RATE

	2021	2022	2023
London	6.0%	4.6%	5.2%

WORKPLACE-BASED EMPLOYMENT GROWTH

	2021	2022	2023
Office	1.4%	1.9%	-0.8%

Source: Oxford Economics

LONDON FLASH PMI DECEMBER 2022

50.2 ▲

Business Activity Index

Activity rose marginally in the final month. However, companies are enacting hiring freezes, and some vacant positions are being left unfilled.

49.5 ▼

New Business Index

New order inflows fell for a third successive month, but softened compared to the previous two months.

64.9 ▲

Future Activity Index

Sentiment increased for second consecutive moth, reflecting reduced concerns regarding the recession and higher financing costs.

49.0 ▼

Employment Index

London businesses registered a marginal reduction in staff for the first time in nearly two years.

Source: IHS Markit
Arrow indicates monthly change

After a tumultuous end to the year, the London economy faces headwinds heading into 2023. Comparatively, London is expected to be one of the best performing of all UK regions, but GVA is still expected to fall by 0.1%.

On the international stage, however, Oxford Economics' global cities outlook point to London being one of the bottom performers amongst international peers, with weak annualised GDP growth of 1.9% over 2023-27.

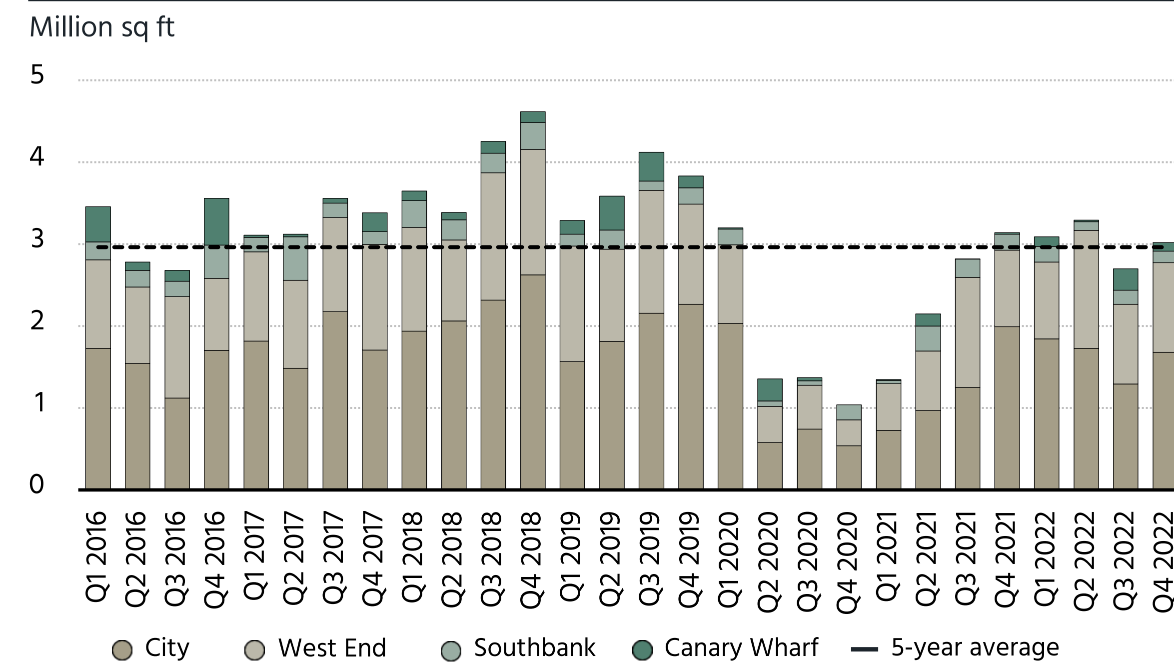
Firms are reporting hiring freezes and are deciding to leave unfilled positions vacant, with flash indicators giving credence to the forecasted 0.6%-pts increase to 5.2% for the unemployment rate over the year.

Concerns regarding inflationary pressures, and the consequent risk to revenues mean expansion plans are now on pause for many. The outlook for office-based growth employment is negative. Real estate activities and financial services are the sectors expected to contribute most, with forecasts showing an employment fall of 1.3% and 1.1% in 2023, respectively.

DEMAND

London office quarterly take-up by broad market

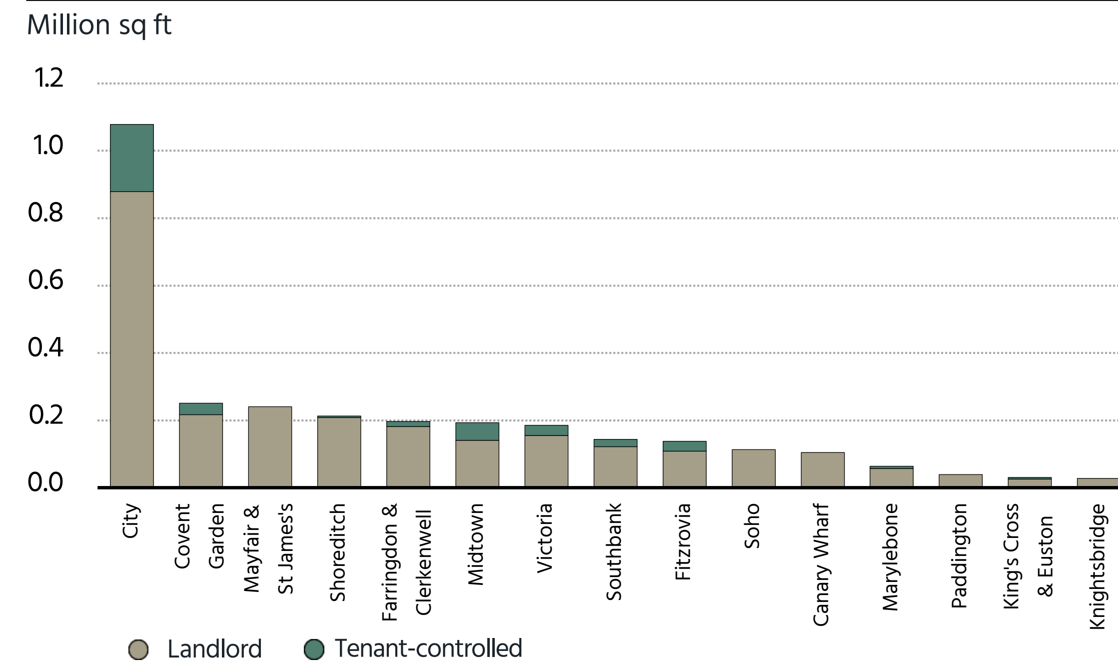
Source: Gerald Eve



Occupier activity finished the year strongly with 3m sq ft of take-up in Q4 2022. This reflects a 10% uplift on the previous quarter and was 2% above the 5-year quarterly average. This quarter's outturn contributed to an annual volume of 12.1m sq ft in 2022, an increase of 28% on 2021. Occupational demand was underpinned by several lettings in larger size bands, with just over 0.9m sq ft signed on leases over 50,000 sq ft. On the smaller scale, under 5,000 sq ft leases made up 0.6m sq ft. This reflects one of the highest volumes in this size band over the last three years.

Take-up by submarket and source of letting, Q4 2022

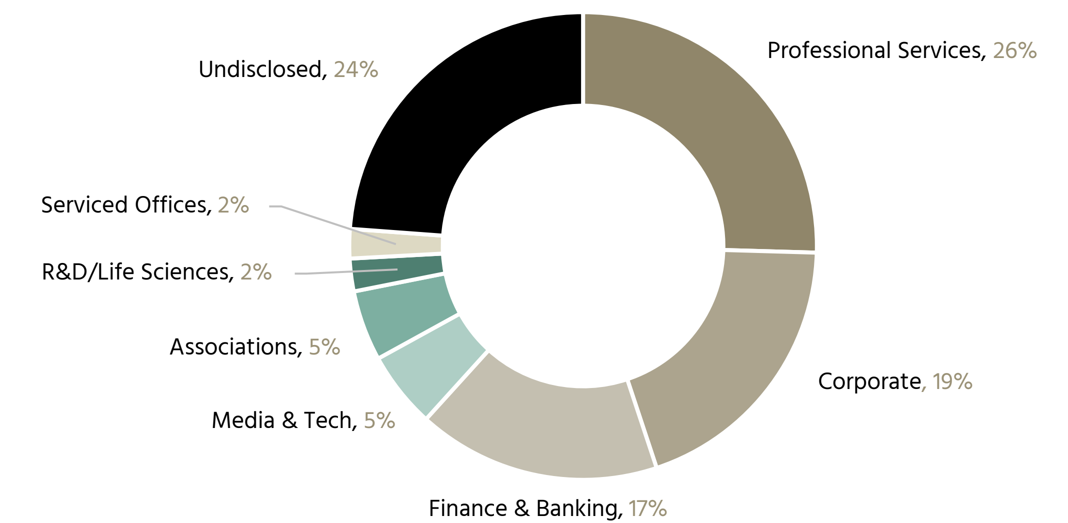
Source: Gerald Eve



By submarket, occupier activity was greatest in the City with just under 1.1m sq ft, with Clifford Chance's 330,000 sq ft lease at 55 Basinghall Street the largest letting of the quarter. Pre-let activity was also strong in schemes that are soon to complete, making up 10% of the overall volume. This contributed to a notable increase in take-up in Covent Garden. The submarket reached the highest outturn since Q2 2017, driven by GSK's future occupation of 145,000 sq ft in The Earnshaw. Tenant-controlled take-up amounted to 13% of overall activity, focused largely in the City.

Take-up by business sector, Q4 2022

Source: Gerald Eve



Professional services companies were the most active in Q4, contributing to just over a quarter of leasing activity, underpinned by robust activity from law firms. Corporates followed with just under a fifth of activity, taking space across a wide range of size bands. Private equity firms were a particularly active subset of the finance and banking sector, accounting for a third of all activity in the sector, with lettings largely focused in Mayfair and St James'. There's been a notable slowdown from media and tech occupiers and H2 2022 marked the lowest half-year of activity on record.

LONDON OFFICE RENTS AND INCENTIVES, Q4 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

MARYLEBONE
Grade A
£95.00
Rent Free 21-24 months

FITZROVIA
Grade A
£92.50
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

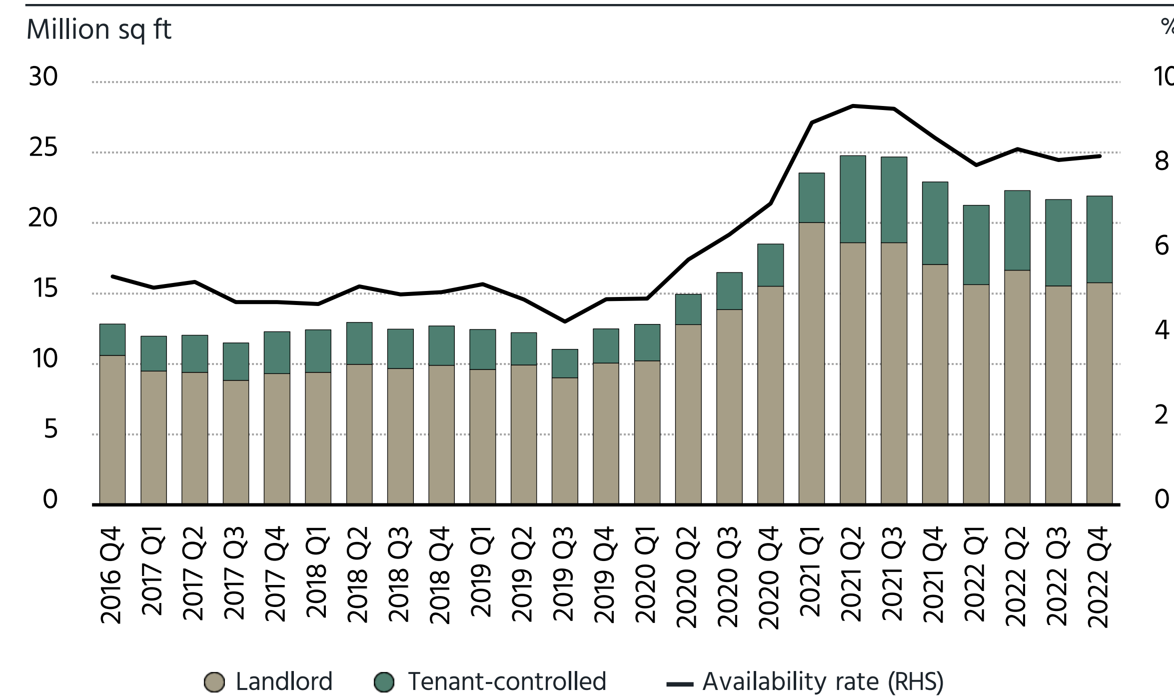
KNIGHTSBRIDGE
Grade A
£95.00
Rent Free 24 months

VICTORIA
Grade A
£79.50
Rent Free 24 months

AVAILABILITY

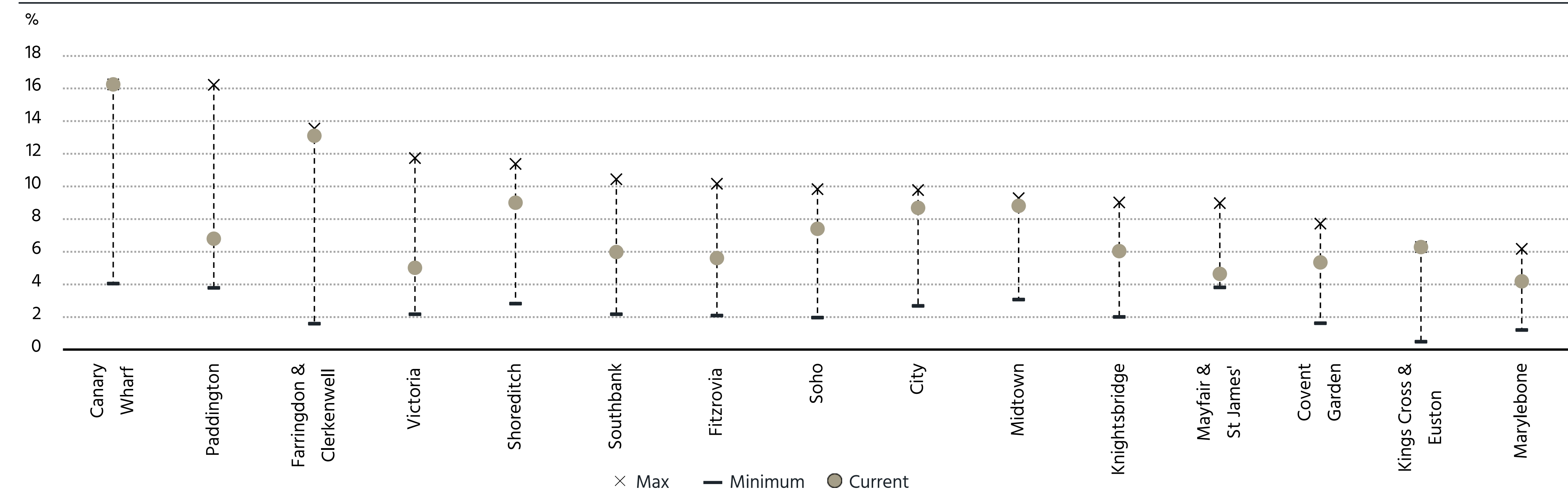
Availability by type of listing and rate

Source: Gerald Eve



Availability rate, historical range by submarket, Q1 2013 – Q4 2022

Source: Gerald Eve



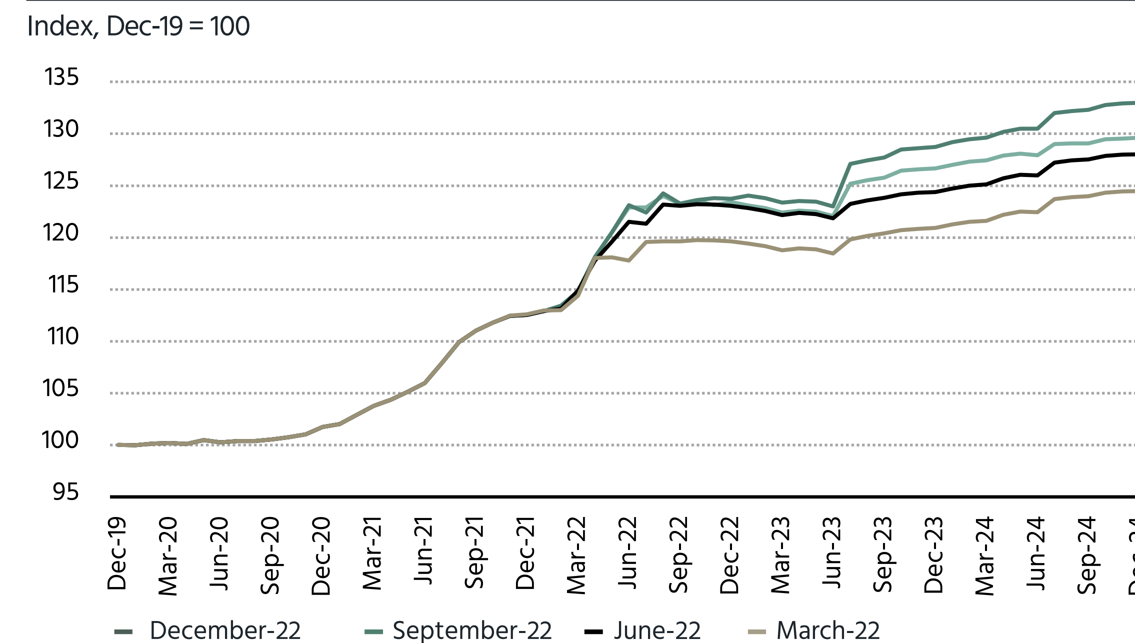
The availability rate remained broadly flat in Q4, settling around 8.2%, with only a minor change on the previous quarter. Landlord controlled availability has been largely consistent over the last four quarters with the level in Q1 2022 similar to the level currently (15.6m sq ft). Tenant-controlled space reached a peak this quarter in both proportional and nominal terms. Estimates show 6.3m sq ft of grey-space is available, corresponding to just under 29% of the overall market. Availability is expected to remain elevated over the year, as occupiers focus activity in new schemes to the detriment of the residual rest.

Availability fell in seven of our 15 tracked submarkets,. Fitzrovia and Covent Garden recorded the largest declines, with falls of 1%-pt and 0.6%-pts, respectively. Notably in Mayfair and St James', availability fell to 4.7% in Q4, reflecting the lowest rate since before the pandemic. Availability in Soho increased by 2%-pts on the back of Lucent and 20 Air Street, which are soon to come online over the next quarter, and appearing in the active availability list. list. Additionally, Canary Wharf reached peak availability of 16.3% this quarter, almost double the rate back at the start of 2020.

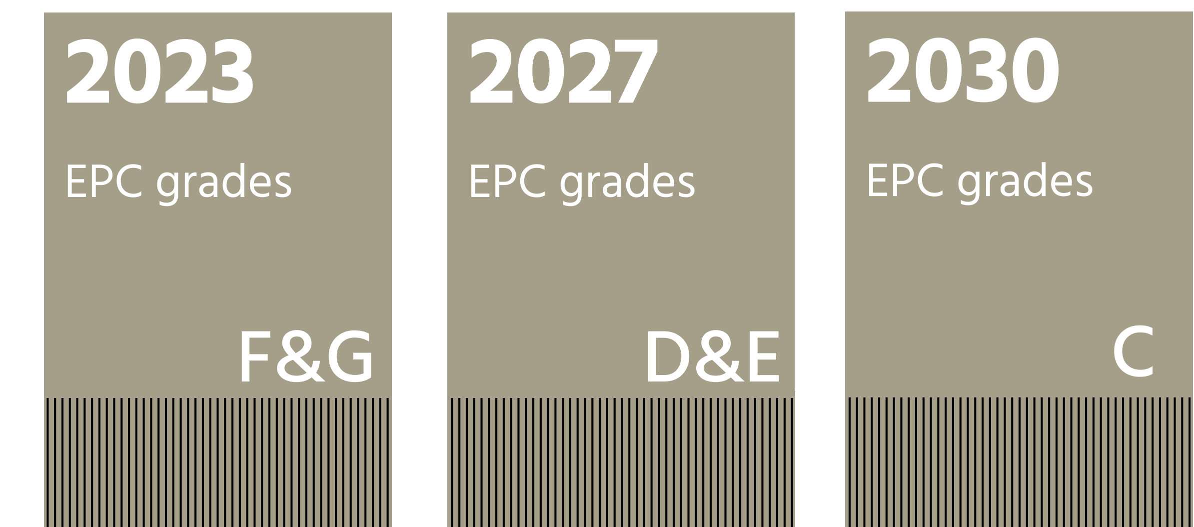
Availability is likely to increase this year given the large number of delayed schemes in the pipeline set against an occupier market facing a recession. Several larger corporates are reviewing space requirements and returning space to the market. Barclays released space back to the market in Q3, and Facebook handed back 312,000 sq ft of never-occupied space in King's Cross in Q4. More companies will be reviewing economic conditions and making decisions to redetermine space requirements due to recessionary impacts on employee count. Additional costs like utilities, business rates and labour will influence these decisions.

DEVELOPMENT

An estimated 200,000 sq ft completed in Q4, bringing overall annual completions to just under 2.2m sq ft. This figure typifies the issues in construction this year. Completions were 70% below the expected 7.7m sq ft originally estimated at the start of 2022. This has led to a bloated pipeline in 2023, with completions expected to reach to 7.8m sq ft. However, positively 38% of the 2023 pipeline is pre-let, especially the space due to complete in H1 this year. Development timelines will be further protracted into 2024, particularly for phased schemes, given the large increase in development financing costs.



General build cost forecasts in December showed another upgrade to cost estimates when compared with three months ago. The BCIS cite increased labour costs which will come into play in the second half of this year. On average, build costs are expected to be 2.9% higher over 2023 and 2024 than forecast in September. Increased build and financing costs will contribute to a limited number of development starts over the next two years. This will only stand to compound the acceleration of upward pressure on prime rents, arising from competition for best-in-class schemes and recouperation of elevated build costs.

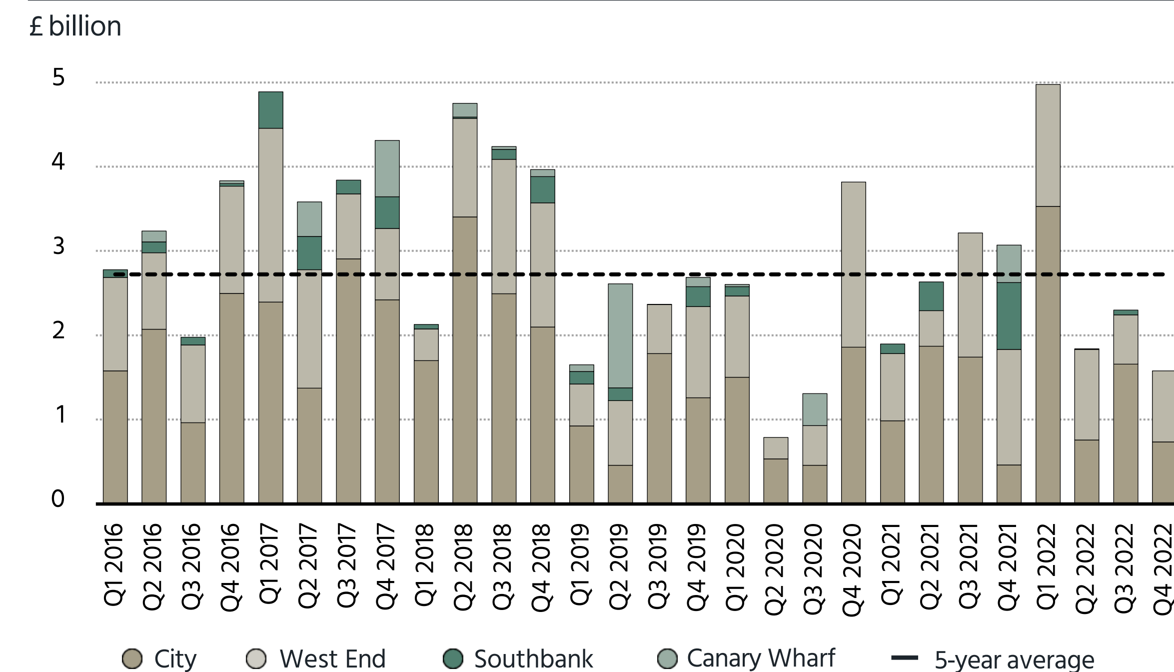


The upcoming MEES deadline in April 2023 will mean any offices with an EPC rating of F or G will become unlettable. Although this does not pose a risk for much of London's office stock, it will act as a poignant reminder for the 2027 deadline for EPC D and below, and 2030 for the C rating cut-off. Post-GFC, the capital's recovery was led by a supply side response through new developments. However, with much of London's office stock not meeting future regulatory requirements, development activity is likely to centre around sustainable upgrades to existing stock rather than new developments.

INVESTMENT

Quarterly investment volume by broad market

Sources: Gerald Eve, Property Data



The investment market was markedly subdued in Q4 as investors stood on the sidelines awaiting the pricing fallout from the mini-budget. This quarter's investment volumes amounted to just under £1.6bn, reflecting one of the lowest volumes on record barring the covid-lows in Q2 and Q3 2020. Activity fell by a third on last quarter's volumes and was over 40% below the 5-year quarterly average. Lazari's £430m acquisition of the Fenwick HQ in Mayfair was the largest of the quarter, making up 25% of the total volume. This meant West End volumes were up 44% on the quarter, while activity in the broader City fell by more than half.

Overseas investors were the most active buyer group over Q4, making £840m of acquisitions across seven transactions. Notably, the group made four of the five purchases on lot sizes over £100m, with these acquisitions characterised by attractive long income and a diverse tenant base.

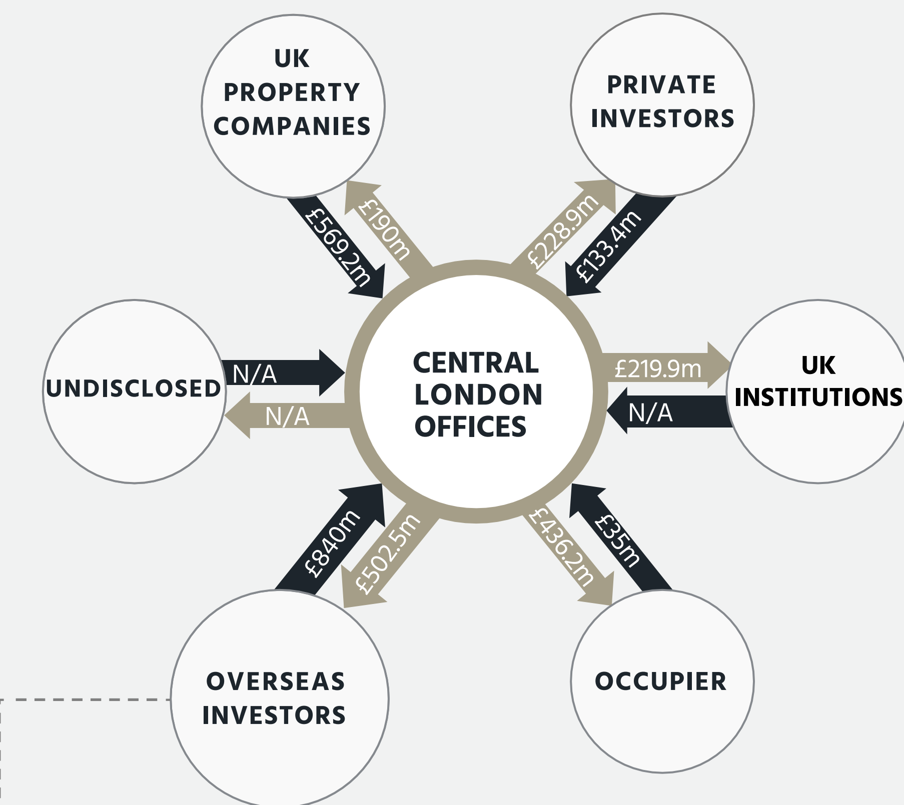
Long-income plays will be the product of choice for overseas investors given the interest rate arbitrage between their domestic markets and the UK. German investors were the most active by sub-domicile, with just over £500m attributed to the group. These investors are likely taking advantage of rate differentials, using preferential lending rates provided by federated Pfandbrief loans.

On the sell-side, UK institutions disposed of £219.5m across six transaction, with lot sizes all under £100m. The majority of these sales were in the West End on smaller office buildings. There was only one disposal for UK propco's, with Great Portland Estates' sale of 50 Finsbury Square for £190m to German investors.

In the direct investment market, previously-marketed sale prices have been chipped by 15-20%, and some sale campaigns withdrawn. Debt costs have quadrupled from this time last year based on 5-year SONIA swaps. There is some mounting risk in the market as there are several buildings which need refinancing over the near term. This has stirred up the possibility of distressed sales, based on increased debt costs. With the valuation drop, some office financing terms may breach LTV agreements set by lenders in a vastly different interest rate environment.

CENTRAL LONDON OFFICE CAPITAL FLOWS, Q4 2022

Source: Gerald Eve, Property Data



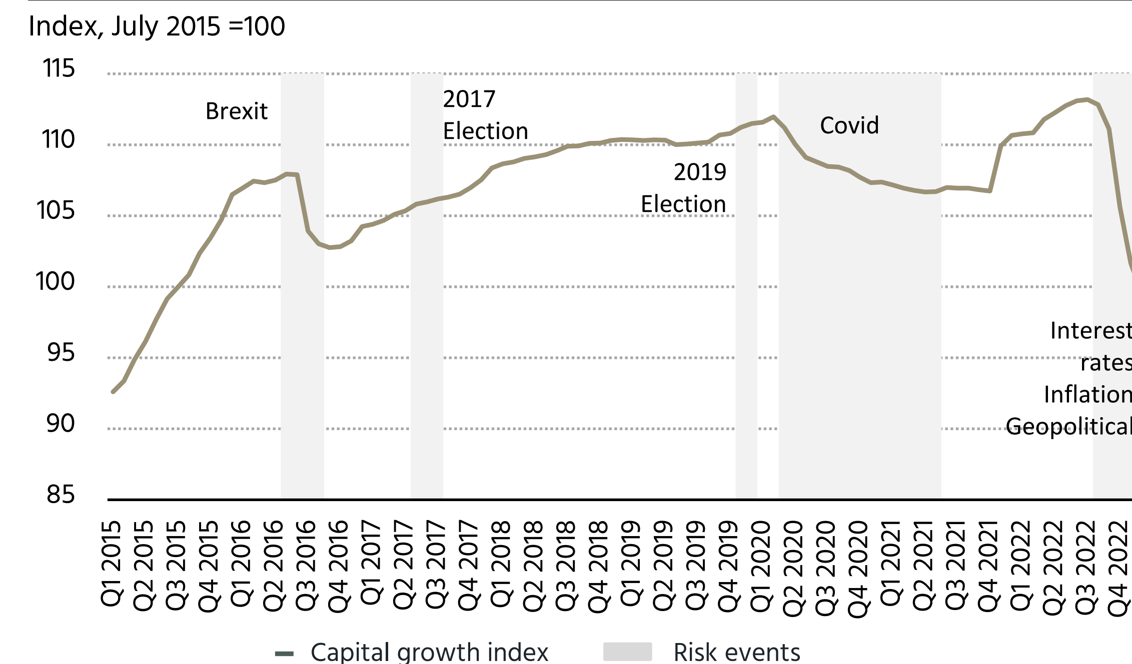
INVESTMENT VOLUME BY INVESTOR SUB-DOMICILE

£502.5M GERMAN	£205.8m APAC	£120m NORTH AMERICA	£11.8m EUROPEAN
52.3% OF OVERSEAS INVESTMENT	33.9% OF OVERSEAS INVESTMENT	12.5% OF OVERSEAS INVESTMENT	1.2% OF OVERSEAS INVESTMENT

REPRICING IMPACT

Central London offices, monthly capital growth index

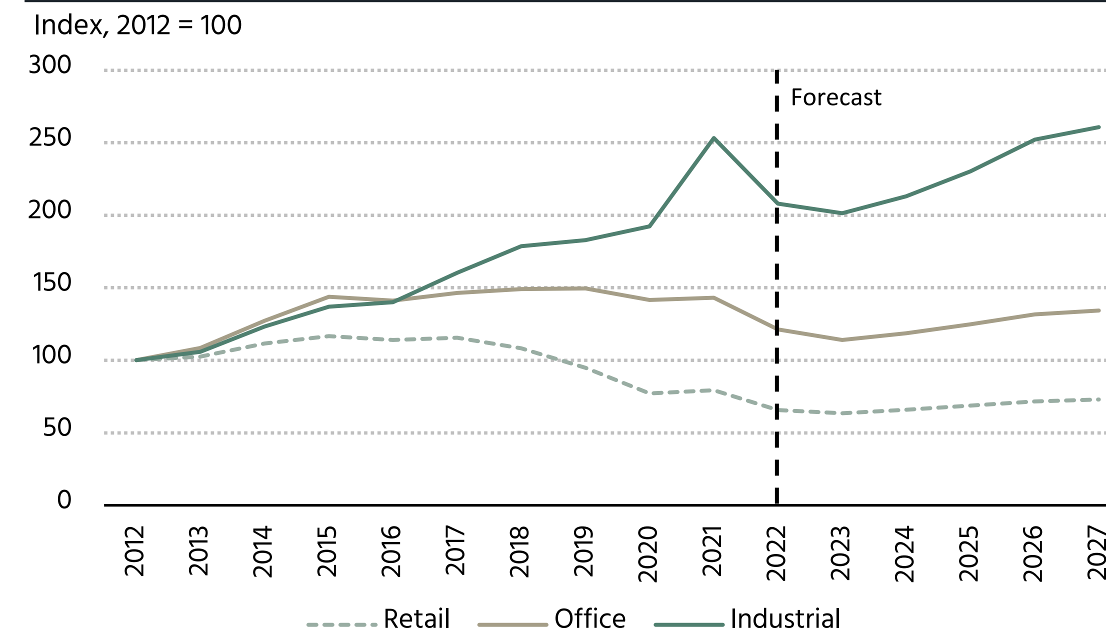
Source: MSCI, Gerald Eve



In the cycle post-GFC, there have been multiple risk events facing the commercial property market. Brexit caused a drop in London's capital values that took 18 months to recover from, elections posed potential major shifts in political trajectory, and the pandemic led to a two year decline in values. Current drivers of risk are more proliferated though. Uncertainty on the length of the looming recession, a cost of living crisis and ongoing geopolitical risk, have all been compounded by rising interest rates. The ongoing ambiguity on where rates end up and for how long they will remain elevated underpins the new investment and valuation cycle.

Valuations-based capital values by sector

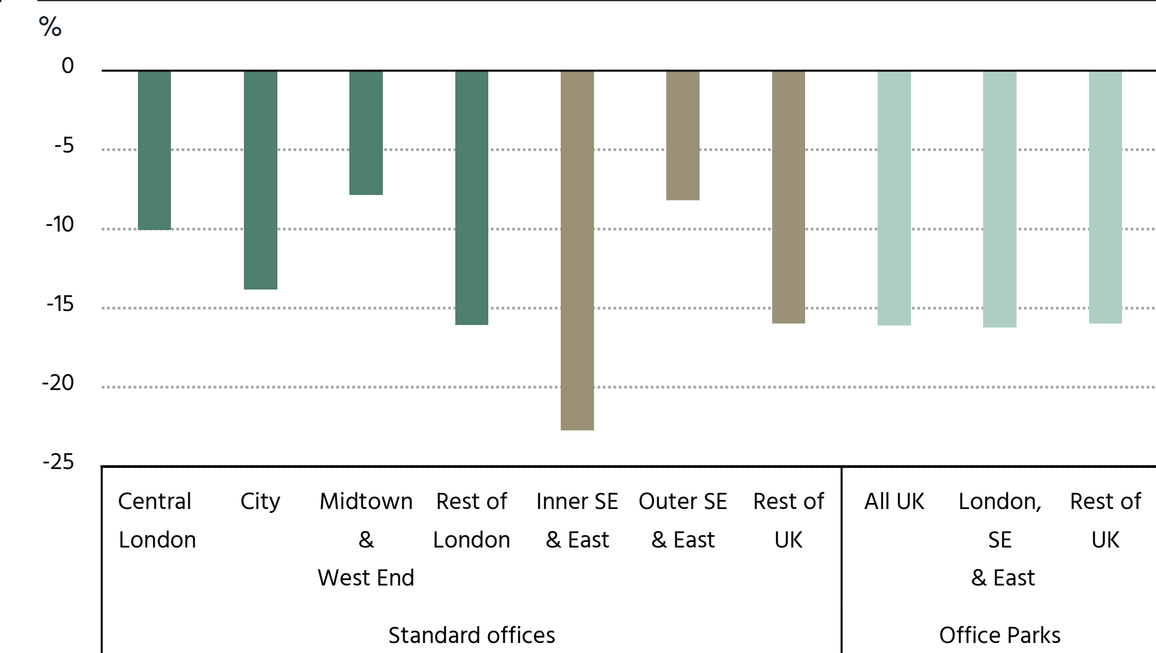
Sources: MSCI, Gerald Eve



The recent outward yield shift in central London offices has led to a sharp correction in values. The monthly December 2022 data show a quarterly fall of 10% in the capital value index since September's ill-fated mini-budget. Office values are expected to bottom out by the end of 2023, coinciding with peak interest rates. In the February MPC meeting, the Bank of England base rate was upped 50bps to 4% from 3.5% previously, and the potential fallout in the labour market and subsidence in inflation will dictate the pacing of future rate hikes. SONIA forward curves show the market still expect rates to reach 4.5% by mid-2023.

Annual capital value growth by UK office segment, Dec-2022

Source: MSCI



In the City, values have fallen by 13.8% compared with the 7.8% in Midtown and the West End. Greater London and rest of UK values have fallen by 16%, signalling the influence that hybrid working has had on occupancy levels in these segments. Facing a similar issue, office parks have fallen by a parallel magnitude. Despite the negative picture, this illustrates London's resilience compared to other UK geographies and out-of-town, with liquidity expected to remain comparatively high. The London office market will undoubtedly face hurdles this year, but there is always opportunity in the capital, particularly when pricing aspirations diverge.

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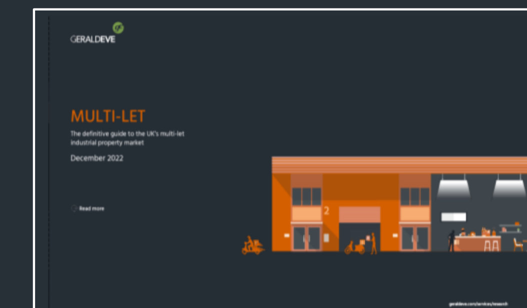
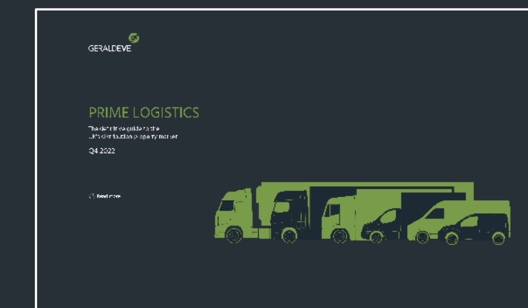
January 2023



Multi-let
December 2022



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