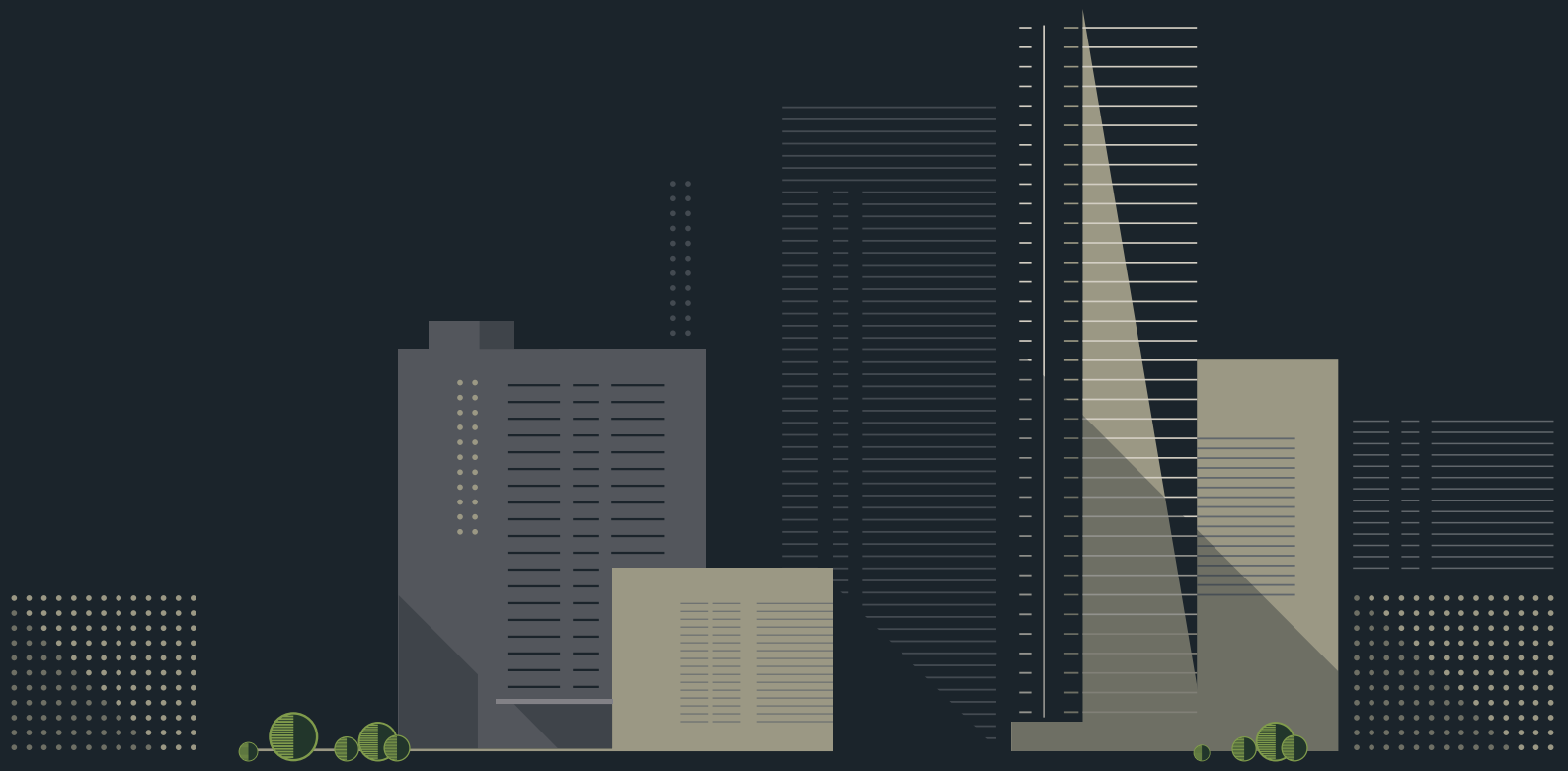
LONDON MARKETS

London office property performance and key themes

Q4 2020



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2021: A YEAR OF TWO HALVES

H1 2021 – LOCKDOWN IMPLICATIONS

- PAUSED OCCUPATIONAL DEMAND
- LIMITED NEW STOCK
- ASSET-SPECIFIC PRICING
- CHALLENGING DEBT MARKET
- REDUCED INTERNATIONAL TRAVEL BUT STRONG SELECTIVE INVESTOR APPETITE

H2 2021 – OCCUPIER-LED RECOVERY

- OCCUPIER GREEN SHOOTS
- GRADE A VS GREY SPACE
- OCCUPIER FOCUS ON QUALITY OF STOCK
- DEMAND FOR SUSTAINABLE STOCK
- SELECTIVE RETURN OF TRADITIONAL BUYERS

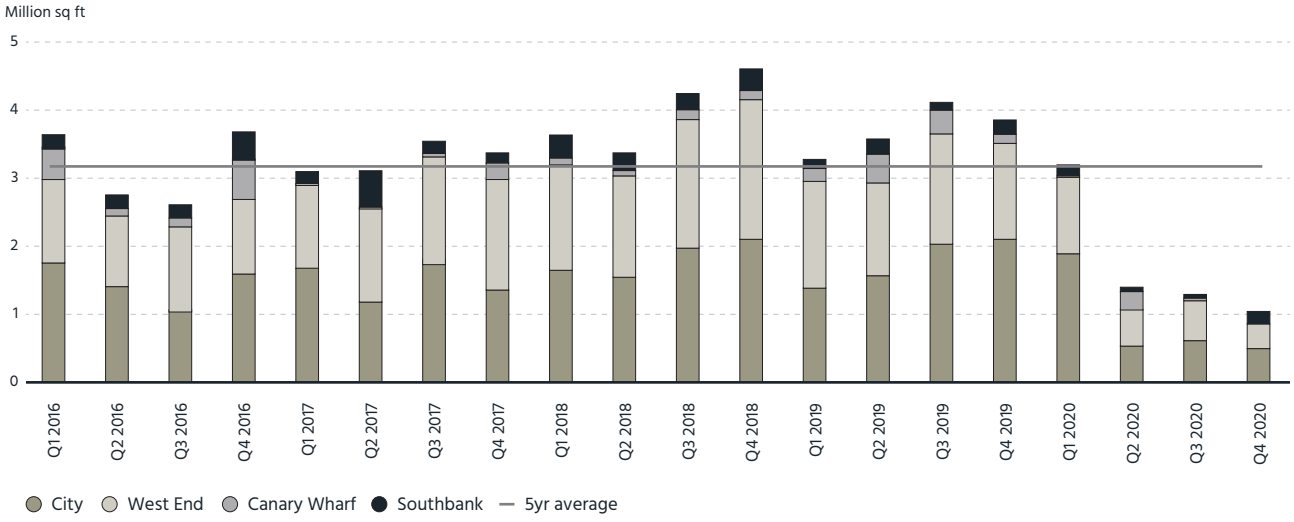
An increasingly accepted view has emerged since last summer's debate over the future of the office, that home-working is not a viable long term solution. Many traditional business sectors are instead discussing the likelihood that adopting a three or four day office-based week will be the norm. The encouraging pace of the Government's vaccination programme is prompting businesses to start re-discussing a return-to-work strategy and we therefore anticipate an uptick in activity in the second half of the year, most notably from emerging industry sectors such as tech and life sciences. In comparison, the release of tenant-controlled availability (or 'grey space') has risen most from traditional sectors to include marketing, media and retail.

Rhodri Phillips, Partner

CENTRAL LONDON OFFICE OVERVIEW

OFFICE OCCUPIER DEMAND

Quarterly take-up by London market
Source: Gerald Eve



The theme for 2020 was one of muted occupier activity, with annual take-up for 2020 totalling just under 7m sq ft. Throughout the second half of the year, occupiers effectively pushed the pause button when approaching lease decisions. Also, the imposition of lockdown on 5th January has pushed business decisions on office space 3-6 months further down the line.

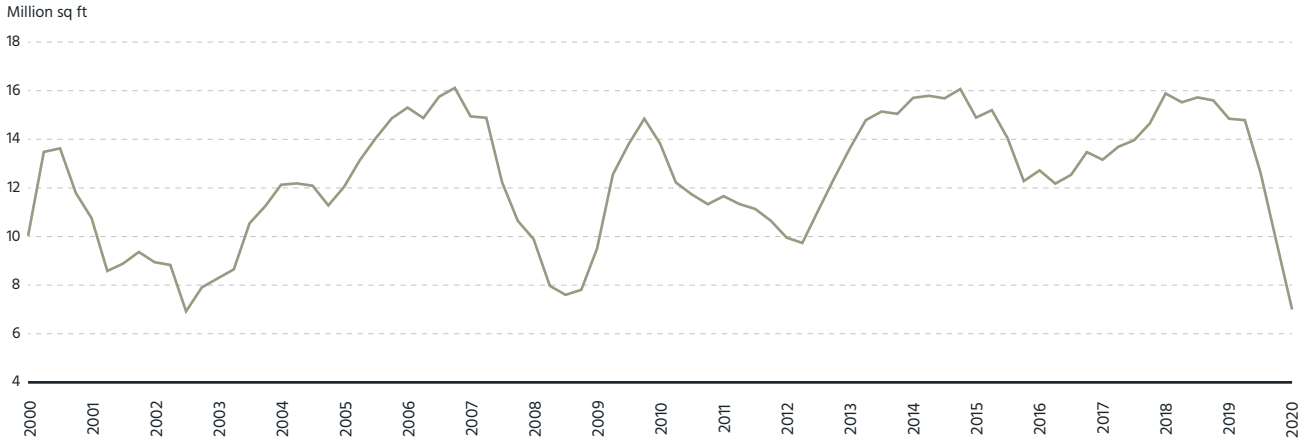
Thus, we expect the trend of reduced demand to continue through Q1 but anticipate activity will pick up towards the summer. By then, business will begin to materially understand and enact strategies on their post-COVID office requirements, with a view to return to the office when vaccine numbers paint a more positive picture.

Leasing activity in H2 2020 was down sharply, with the total amounting to 2.35m sq ft. Activity in Q3 totalled 1.3m sq ft, while Q4 marked a record low quarterly volume of 1.05m sq ft. Respectively, these levels are 59% and 67% below the previous five-year quarterly average. On a rolling 4-quarter basis, this marks the lowest level of occupier activity since our records began in 2000 and even lower than the level seen during the GFC.

However, unlike the GFC, the sharp drop in demand at present, does not mark a structural shift but a frictional period in activity. This is because there is not a dearth of demand like in 2008-2009, where all sectors, including office-based services, were simultaneously hit by the poor economic situation.

Over the last year, office-based services have been able to continue to function almost as normal through homeworking and have not seen extensive job losses as in the GFC. The wait-and-see approach occupiers have adopted means there is pent-up demand waiting on the side lines, owing to the current frictional nature of London office demand.

Central London office take-up, 4-quarter rolling average
Source: Gerald Eve



THE VIEW ON RENTS

The lack of recent transactional evidence makes quantifying rental movements difficult. Landlords have maintained headline rents for high quality stock at pre-COVID levels but have shifted to more flexibility within lease terms. This has meant that the projected sharp fall in rental values feared during the first lockdown did not materialise through 2020.

New leases signed during H2 2020 continued to include increased incentives for a typical 10-year lease, with overall incentive packages moving out by three months across all London submarkets. For example, incentives in the City were 24 months pre-COVID, but have since shifted to a maximum of 27 months. There is a lack of evidence to suggest that incentives have shifted out further than this.

Given there is such a varied level of lease lengths available on the market currently, medium to large occupiers are attempting to capitalise on this increase in incentives through leveraging their scale on deals on larger buildings and longer lease terms. Therefore, there has not been a large acceleration towards shortened lease lengths, particularly for larger space.

Landlords have also begun to offer a degree of flexibility in start dates for leases, increasing lead times between signing and move-in dates. This increase is obviously necessary given the coronavirus lockdown, but it has also broadened occupier options. Pre-COVID, a tenant would attempt to line up expiry on their existing space with the move-in date for new space, but this would limit what stock was available to the occupier.

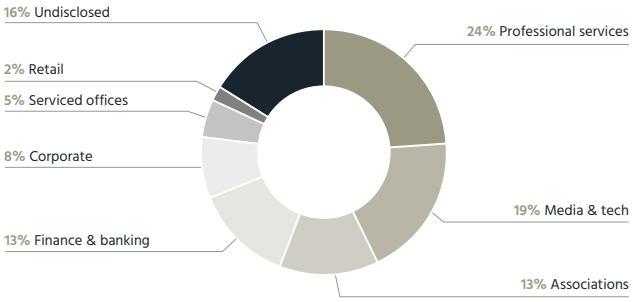
This offer widens the window, and expands the cross-over, when space can be taken. From the landlord's perspective, this has helped secure tenants in a difficult market and protect the future income profile of the asset.

> There have been some strong winners and losers in the private equity sector. Those who have invested in pharmaceuticals and on-line retailers will continue to seek out high quality offices in the prime Mayfair/ St James's market. Conversely, those with underperforming funds during the pandemic may seek to downsize, which means an increase in tenant space in the core West End.
>
> **Pat Ryan, Partner**

DEMAND AND SUPPLY DYNAMICS

OCCUPIER SECTOR SUMMARY

Take-up by occupier sector, H2 2020
Source: Gerald Eve



Professional services occupiers continued to be the most active occupier sector in the second half of the year, taking 572,000 sq ft. Over the whole year, they have been the most acquisitive sector, and made up 27% activity following on from the strong level of demand shown in H1 2020. In Q4, activity in the sector came almost exclusively from law firms, totalling 280,000 sq ft, the largest of which was Slaughter and May's renewal at 1 Bunhill Row for an additional 10 years.

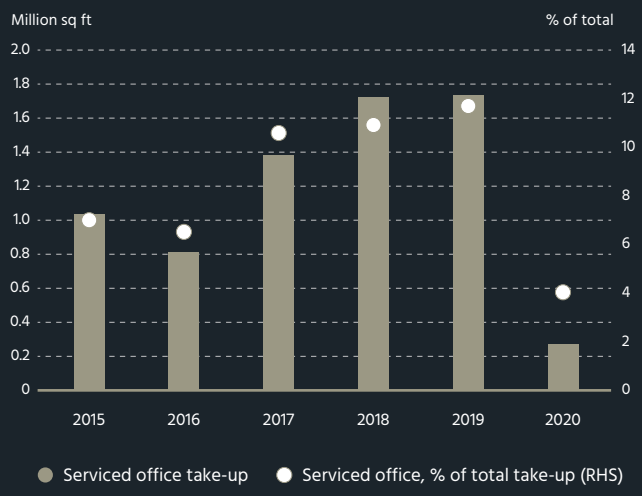
The **Media and Tech (TMT)** sector took 433,000 sq ft of space, accounting for 19% of activity in H2 2020, with most activity centralised in the West End market, as occupiers such as Twitter and Netflix took 31,000 sq ft in Soho and 88,000 sq ft in Fitzrovia, respectively. Within this sector, post-production services were particularly active, Lonely Boy Studios and Proposition Studios both took production space, totalling 144,000 sq ft, in 60-72 Upper Ground in Southbank, on a 1-year and 3-year lease, respectively.

When there was similar disruption to the market during and post-GFC, the mix of London occupier sectors changed in response. Financial services were dominant, but this shifted to more pronounced activity from TMT and Professional Services sectors. In this current phase, the mixture of use classes and shift to reposition some buildings could provide more diverse occupational demand over 2021. This could arise from non-traditional growing sectors such as Medical, Healthcare, and Education, which could absorb some of the surplus supply.

SECTOR FOCUS

Sharp fall in demand from Serviced Office sector

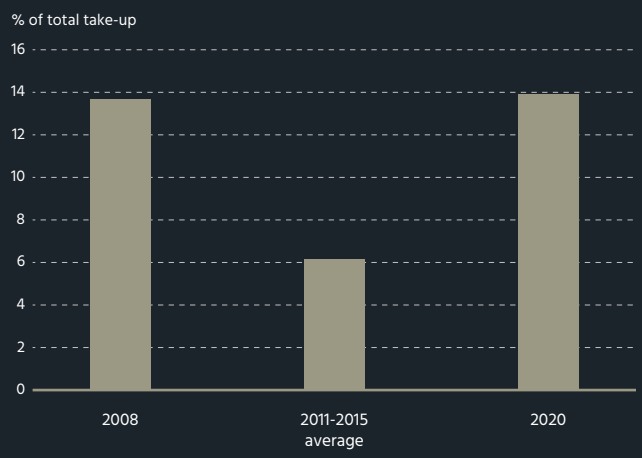
Source: Gerald Eve



- Rapid expansion now working against operators
- Annual Serviced Office take-up in 2020 fell sharply by 84% compared with 2019
- Lowest volume of absolute and relative take-up in the last six years
- On average, occupancy in UK City Centre serviced offices declined by 28% from Q1 to Q3 2020
- Meanwhile, in UK Regional Outer City locations occupancy increased by 12%

Law firms – Watch this space...

Source: Gerald Eve

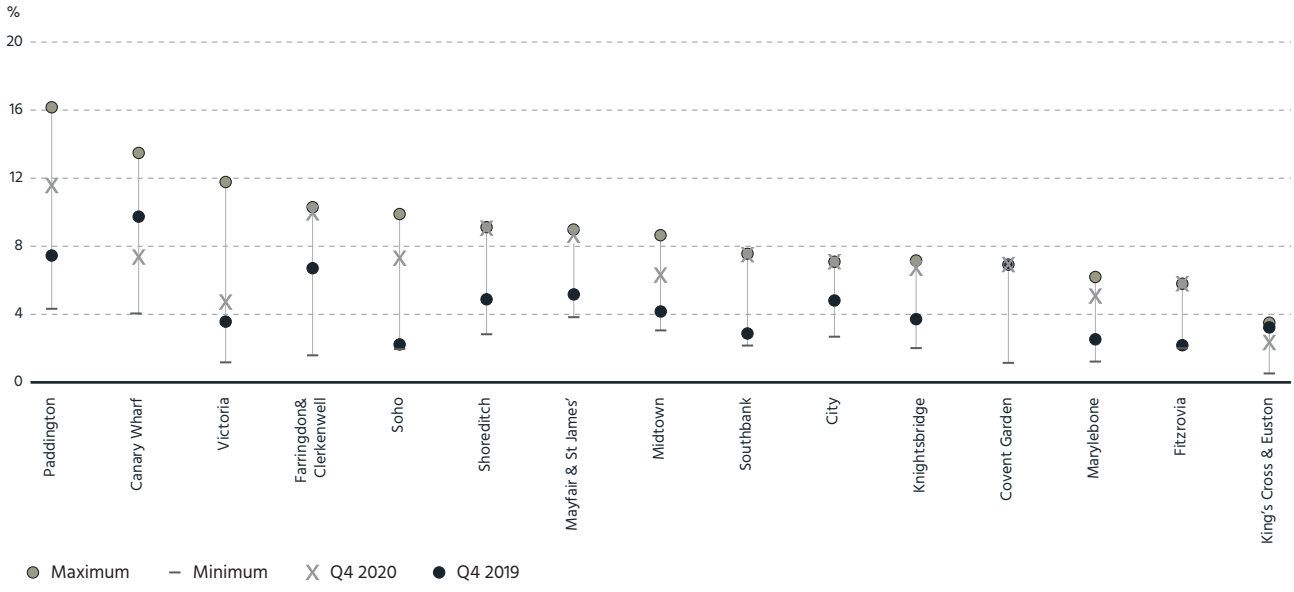


- Analysis of law firm historical take-up shows that they looked to capitalise on market disruption during the GFC
- In 2008 they accounted for 14% of all activity
- Proportional trend is almost identical in 2020
- Activity this year constitutes 13.9% of total take-up
- Perceived market disruption over 2021 means this could act as a boost for activity if Law occupiers believe they can secure more favourable lease terms
- This is likely to be on a gross basis as firms look to re-gear leases rather than expand into additional space

SUPPLY AND DEMAND DYNAMICS

AVAILABILITY AND SUPPLY

Availability rate, historical ranges by submarket, Q1 2013 to Q4 2020
Source: Gerald Eve

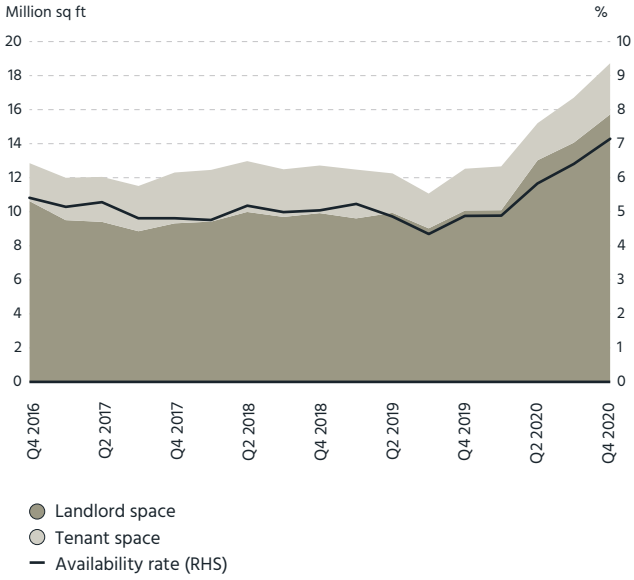


Availability in London increased by 0.7%-pts from 6.4% in Q3 to 7.1% in Q4. In our Summer edition, we reported that a large proportion of submarkets remained below their peak availability. But as occupier demand has been severely dampened across all submarkets, there has been a shift towards historical peaks.

The City, Shoreditch, and Southbank are now at peak availability rates over the time range, while Farringdon & Clerkenwell availability is marginally below the historical high. In the City, this is partly due to an increase in stock, with completions totalling 2.4m sq ft in the submarket in 2020.

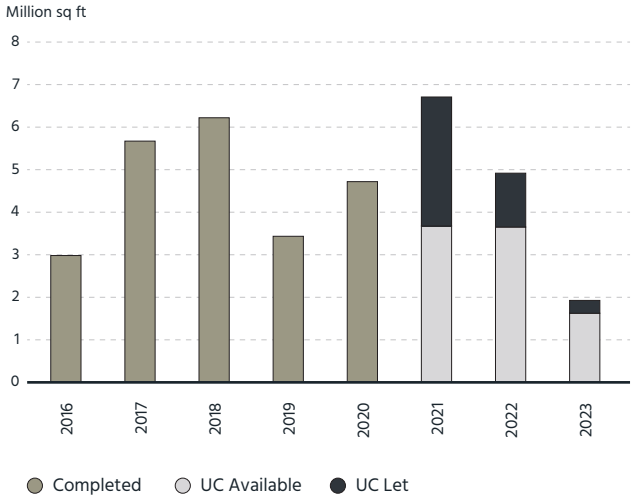
Tenant-controlled space has continued to rise over 2020, reaching 3m sq ft at year end. Our data shows that this level is the highest absolute figure since Q1 2018. Since Q2, over 800,000 sq ft has been released by tenants. Proportionally, the largest rises were in Shoreditch, Soho, Southbank, and Victoria, with sub-let space accounting for over 20% of availability in all of these markets.

Central London availability rate and origin of space listed
Source: Gerald Eve



DEVELOPMENT

London office development pipeline
Source: Gerald Eve



COVID restrictions on construction sites were eased in Q3. Construction sites adapted well to introducing safe guidelines to continue working on developments, but ongoing interruptions and temporary closures have extended delivery times on some schemes. These extensions lowered the volume of completions in H2 2020 and only 4.7m sq ft of office space.

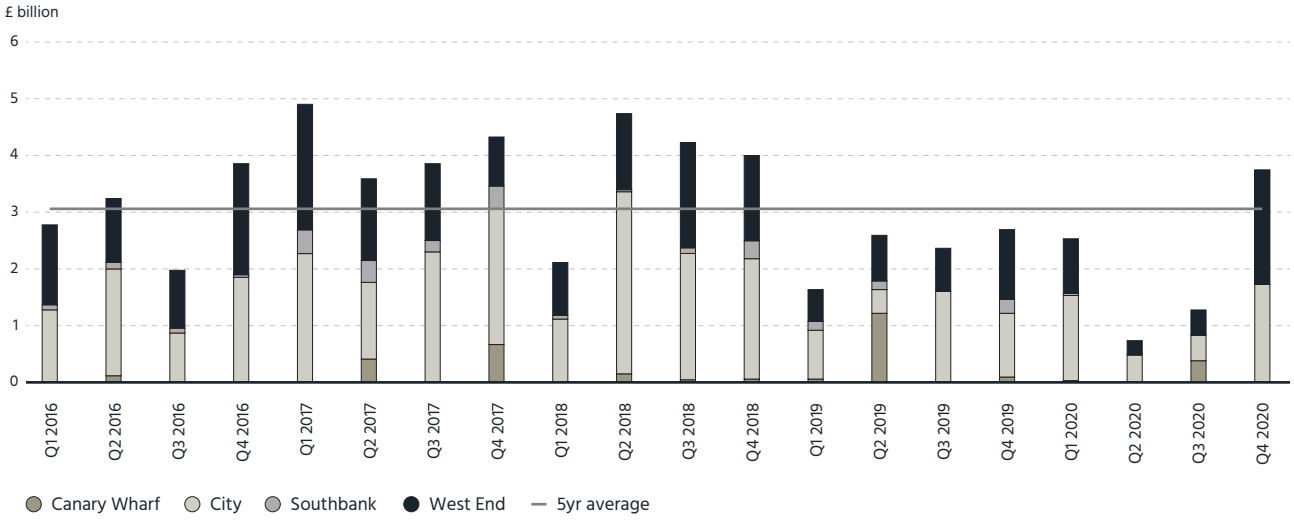
The pipeline also shows that the volume of projects expected to deliver in 2022 has increased. The expected level in summer was for 2.4m sq ft to be delivered but this figure is now at 4.9m sq ft. In the current low demand environment, schemes that have planning approval have a disincentive to begin without pre-lets, especially given the ongoing uncertainty surrounding what building specification will be most in demand by occupiers post-COVID.

Viewed through an ESG lens, this protraction offers an opportunity to adjust planning to incorporate more environmental efficiency in terms of energy output, air systems and heat retention. It is expected that occupiers will be more demanding than ever for sustainable offices, and developments in planning stages could be adjusted to capture such occupier requirements. First movements by large institutional developers who promote a zero-carbon environment in new developments will dictate the shape of future supply.

CENTRAL LONDON CAPITAL MARKETS

INVESTMENT

Investment volumes by main sub-market and 5-year quarterly average
Sources: Gerald Eve, Property Data



ROBUST Q4 INVESTMENT ACTIVITY ENDS 2020 ON A POSITIVE NOTE

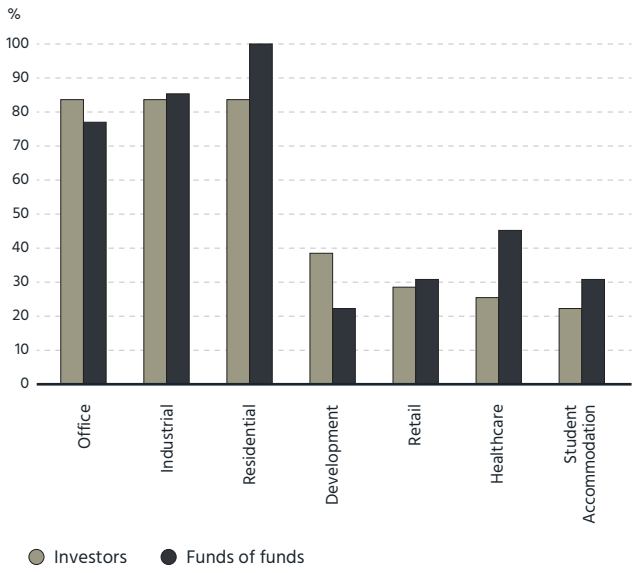
Investment activity over the year in London offices was rather mixed but ended strongly with a healthy level of activity. The investment volume was £5.0bn in H2 2020, 54% above the level recorded in H1 2020. This was heavily skewed with £3.75bn of acquisitions made in Q4, which accounted for 45% of the annual total of £8.3bn in 2020.

From March onwards, capital aimed at London offices was unable to be deployed given travel restrictions and limitations on viewings. Hence why there was urgency towards the end of the year to allocate capital. Although virtual viewings could take place, this is not a fully comparable substitute when conducting due diligence and does not replace an investor physically seeing the asset.

Some well-known London assets that would have come to market were put on hold. From a seller perspective, reduction in the international buyer pool because of restricted travel reduces price competition between investors, potentially acting as a drag on the sell value, disincentivising bringing an asset to market. The anticipated lifting of international travel bans, sale campaigns now coming online, and pent-up capital demand will act as a boost for investment in 2021.

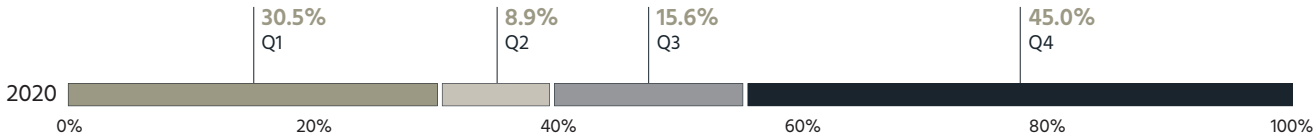
Most preferred investment sectors for 2021 by respondent type

Source: INREV Investor Intentions Survey 2021



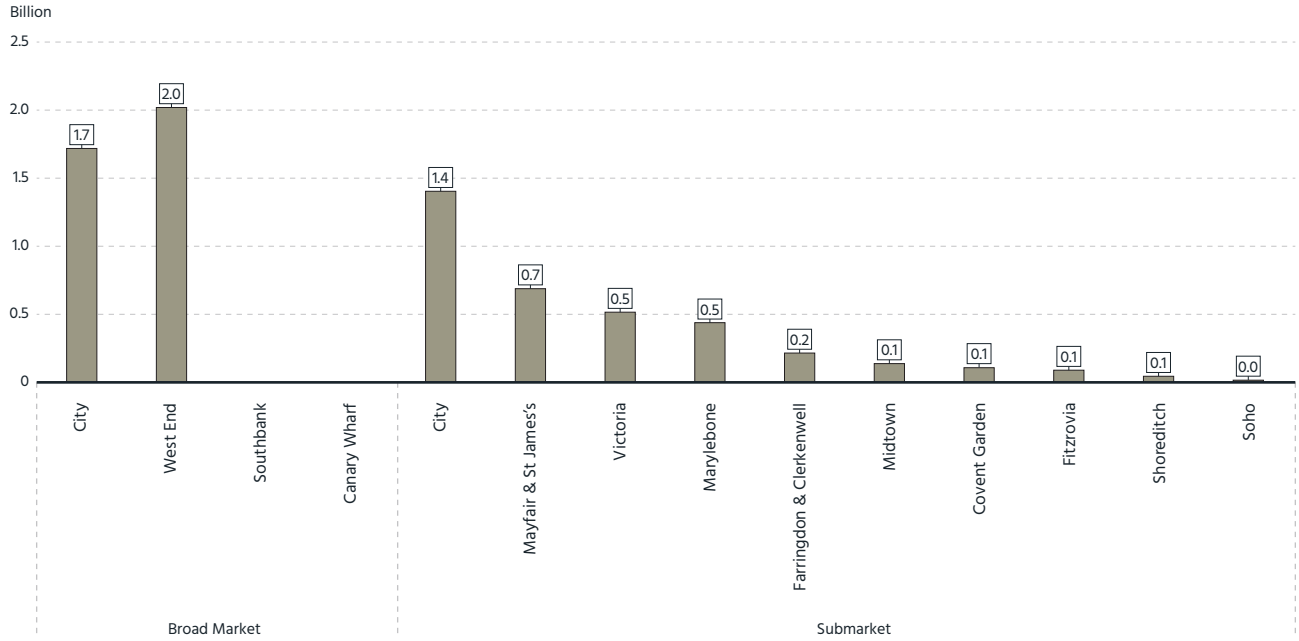
- The latest INREV Investor Intentions Survey shows office, industrial and residential are considered the most attractive sectors by Investors and Funds of Funds.
- 84% of Investors responded with offices as one of their most preferred sectors.
- Current market conditions and availability of suitable product present obstacles to deploying this capital.
- Office assets that come to market, particularly prime, will attract high investor demand.

PROPORTIONAL INVESTMENT VOLUME BY QUARTER, 2020



INVESTMENT

Investment volumes by submarket, Q4 2020
Sources: Gerald Eve, Property Data



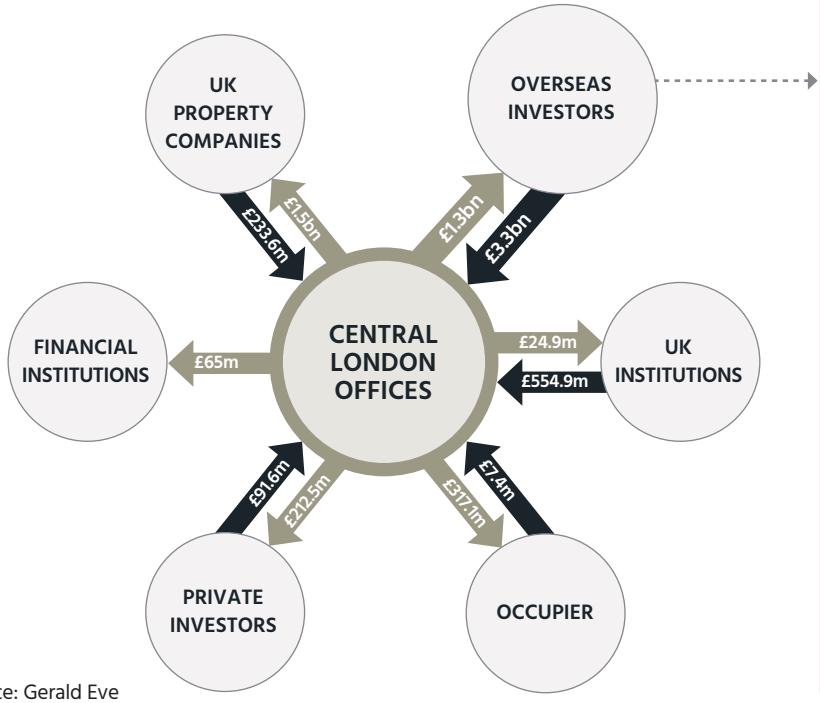
There is currently a healthy demand for prime assets in central London with a focus on acquiring assets with strong leasing credentials. Investment by submarket has shown a flight to quality. Within the West End, Mayfair & St James's was the most active market with £692.2m worth of acquisitions in Q4. This was largely focused on core St James's, with Lifestyle International's sale and leaseback of 1 St James's Square and PG Inmobiliaria's purchase of 21 St James's Square for £205.1m and £187.5m, respectively.

The same is true for demand in the broad City market, where investment in Q4 2020 totalled £1.7bn, focused mostly in the Square Mile which accounted for 81% of the volume across the City. Singaporean based investor Sun Venture made the largest acquisition of the quarter through their purchase of 1&2 New Ludgate for £552m at a 4% yield.

Three of the top 10 acquisitions in the West End and City over £100m were traded at lower than 4% yields, however, there is not enough evidence of this yet to suggest that prime yields have materially shifted. A high level of demand for prime London office is reducing the barriers to entry and exit, which could be further supportive of yields remaining where they are, or even compressing further for the most prime stock.

There has been little activity across non-prime stock with investors preferring to allocate to best in class during this period of uncertainty. The drying up of liquidity for secondary assets will lead to some pricing correction over 2021, as investors will seek to achieve discounts because of lower competition in the buyer pool, occupational desirability of the asset, and scarcity of sustainable office buildings within this segment.

CENTRAL LONDON OFFICE CAPITAL FLOWS BY PURCHASER TYPE



INVESTMENT VOLUME BY INVESTOR SUB-DOMICILE

£1.6bn FAR EAST	47.3% OF OVERSEAS INVESTMENT
£578m GERMAN	17.7% OF OVERSEAS INVESTMENT
£565.8m EUROPEAN	17.3% OF OVERSEAS INVESTMENT
£498.1m MIDDLE EAST	15.2% OF OVERSEAS INVESTMENT
£84.1m US	2.6% OF OVERSEAS INVESTMENT

Source: Gerald Eve

The breakdown of London office capital flows show that overseas investors were the most active buyer type in Q4, as they made £3.3bn of acquisitions, accounting for 87.2% of all activity. With £1.2bn of disposals, they have increased their net exposure to London offices by just over £2.0bn. By contrast, UK Property Companies were the most active seller, disposing of £1.5bn of assets, decreasing their position by £1.3bn.

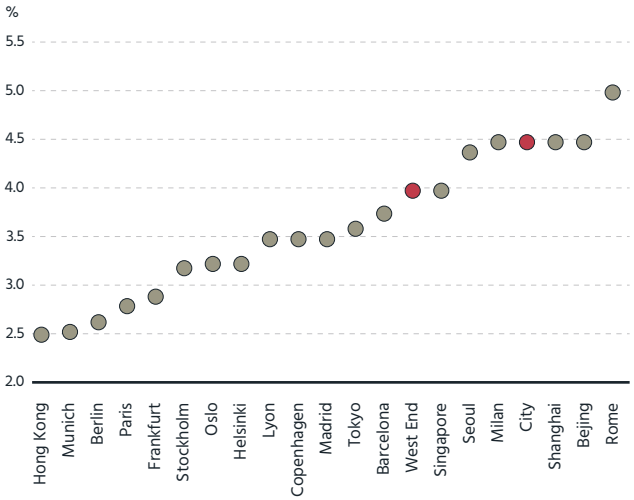
By investor domicile, Far East investors were the most active, acquiring £1.6bn of London offices. This may in part be a geopolitical play as Hong Kong investors were particularly active in acquiring prime stock in the West End, spending £430.1m across three transactions. A preference to allocate capital to a more transparent and stable market such as London, may influence Hong Kong investors' activity further as they seek to move capital in a turbulent domestic political landscape.

Overseas investors accounted for 78% of investment activity in 2020

THE RELATIVE VALUE OF LONDON OFFICES

Global Prime Office Yields, Q4 2020

Source: Gerald Eve International Alliance



COMMITMENT FROM OVERSEAS INVESTORS TO REMAIN STRONG OVER 2021

The investment activity in Q4 is symptomatic of investors' current search for value, which was evident from the positive level of activity in London from Hong Kong and German-based investors. With prime Hong Kong office yields at 2.5%, City and West End offices offer a 1.5-2% spread on an investor's domestic market. The same is true for Germany, with the core office markets of Munich, Berlin, and Frankfurt trading below 3% yields. Based on the pricing across other global centres, London offers fair value in relative spread and will continue to attract overseas investor demand.

The Gerald Eve International Alliance is a network of independent real estate advisors across Europe, the USA, Canada and beyond. Our leading experts can offer you advice, where you need it.

Click **here** to read more about our approach.

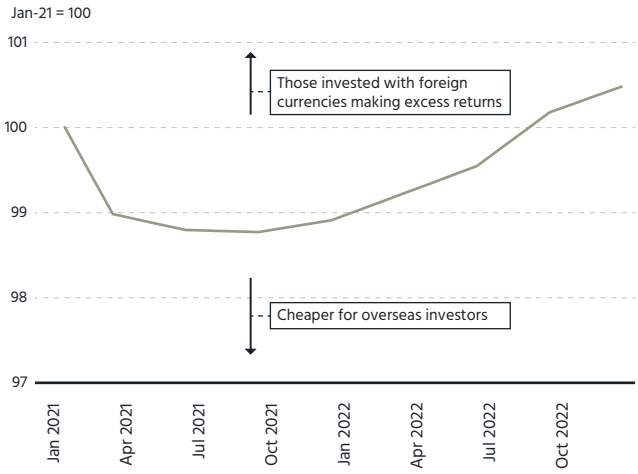
Sterling remains relatively cheap in a historical sense with the current trade-weighted index value at the end of January, 2.7% below the 10-year average. The forecast shows worsening performance of the pound over 2021 owing to Brexit and Covid related fluctuations.

There is a window of opportunity for overseas investors to capitalise on cheaper London assets through relative value currency plays. This is likely to extend until mid-2022.

Despite the forecast uplift past this year, Sterling is expected to remain below its 10y average level through until the end of 2024, providing a further boost for the investment case of overseas investors.

Sterling Trade-Weighted Index Forecast

Sources: Gerald Eve, Oxford Economics



THE LONDON ECONOMY

LONDON AND THE REST OF THE UK GVA FORECAST

	2020	2021	2022
London	-9.4%	5.0%	6.2%
UK excl. London	-10.2%	5.6%	5.7%

UNEMPLOYMENT RATE

	2020	2021	2022
London	5.6%	7.2%	5.9%

LONDON EMPLOYMENT GROWTH BY SECTOR

	2020	2021	2022
Office	-1.4%	-1.6%	3.2%
Non-office	-2.1%	-3.0%	4.2%

LONDON FLASH INDICATORS

46.7

New Business Index

COVID-19 lockdown and post-Brexit trade rules led some clients to cancel orders

47.2

Outstanding Business Index

Backlog of work reduced for fourth consecutive month linked to reduced new order inflows

78.2

Future Activity Index

Firms are hopeful the pandemic's impact will ease considerably as vaccine number rise

Source: IHS Markit

(figures below 50 signify contraction)

RECOVERY PROSPECTS REVISED DOWN FOLLOWING LOCKDOWN 3.0

The impact of COVID-19 on London's GVA was less than anticipated but still severe and the imposition of the third national lockdown on 5th January will act as a drag on growth in the earlier stages of the year. Oxford Economics changed its outlook for the city, recording a decline of -9.4% in 2020 compared with the forecast of -9.7% in summer. With London's GVA growth forecast revised down to 5.0% this year (from 9.6%).

In the broader regional context, London will continue to lead GVA growth between 2022-2025, but the historic gap between the city and the regions will reduce. On average over the last 10 years, London accounted for 25% of all working age migration to the UK. This higher dependency compared with the rest of the UK will constrain the labour pool given Brexit and the influence on migration.

SOCIAL RESTRICTIONS WILL PROTRACT LONDON'S EMPLOYMENT RECOVERY

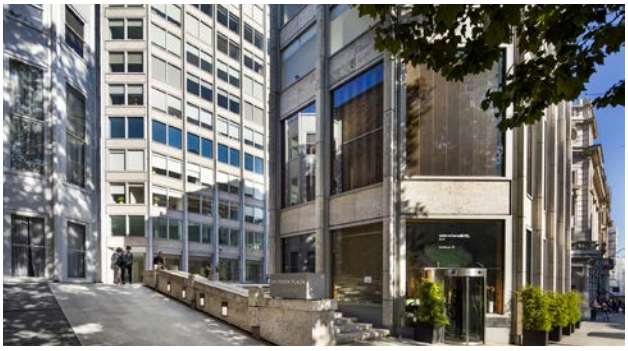
The restrictions' stark effect on employment within the most vulnerable sectors can be seen by changes in Accommodation and Food Service, and Arts and Entertainment, which fell by 5.9% and 6.5% respectively in 2020. However, office employment, protected by a greater capacity for homeworking, meant there was less impact, with an estimated fall of -1.4% in 2020.

The outlook for the office sector is more positive. Falls in the sector's employment are expected to be lower than the London average, with employment set to grow by 3.2% in 2022, pushing the employment level above its pre-pandemic level. There are headwinds to office sector employment in the near term, but a strong rebound will underpin demand for office space in future.

GERALD EVE IN THE MARKET

2 Cavendish Square, W1

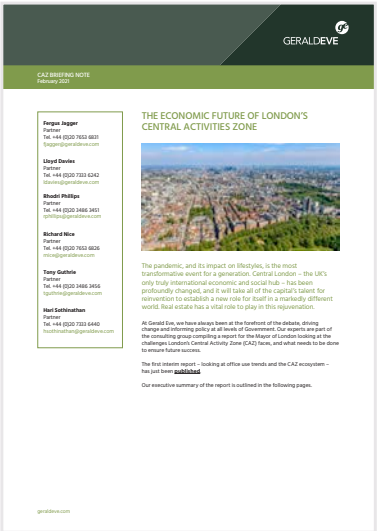
Acting for The Howard de Walden Estate, we have leased 18,000 sq ft upon completion of a comprehensive refurbishment over lower ground, ground to third floor. Terms were agreed with HCA International for their new London head office on the basis of a 15 year lease with break after 10 years, at a blended rent of £87.55 psf.



Denham Building, Smithson Plaza, St James's, SW1

Acting on behalf of Tishman Speyer and prior to their successful sale of the Smithson Plaza holding in December, we re-let a floor of 1,300 sq ft delivered fully fitted and furnished, further underlying the demand at this size range for suites that are ready for immediate occupation. Terms were agreed to Aerius Associates on the basis of a 3 year term with break after 2 years at £90.00 psf.

FURTHER INSIGHT



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CAZ BRIEFING NOTE
February 2021

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THE ECONOMIC FUTURE OF LONDON'S CENTRAL ACTIVITIES ZONE

The pandemic, and its impact on lifestyles, is the most transformative event for a generation. Central London – the UK's only truly international economic and social hub – has been profoundly changed, and it will take all of the capital's talent for reinvention to establish a new role for itself in a markedly different world. Real estate has a vital role to play in this rejuvenation.

At Gerald Eve, we have always been at the forefront of the debate, driving change and informing policy at all levels of Government. Our experts are part of the consulting group compiling a report for the Mayor of London looking at the challenges London's Central Activity Zone (CAZ) faces, and what needs to be done to ensure future success.

The first interim report – looking at office use trends and the CAZ ecosystem – has just been published.

Our executive summary of the report is outlined in the following pages.

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CAZ briefing note
February 2021

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PLANNING BRIEFING NOTE
February 2021

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LONDON PLAN PUBLICATION 2021

On 29th January 2021, following extensive exchanges and revisions, the new London Plan was authorised by the Secretary of State and the Mayor can now proceed with its publication.

It has been a relatively drawn out and politicised process to get to this point. Following Sadiq Kahn's election as the Mayor of London in 2016, the GLA swiftly commenced the preparation of a new London Plan to replace the previous Mayor's version, to reflect his vision and ambitions for the next 20 years, and the policies and issues on which he was elected. This was with the aim of delivering a new plan within his first term – an ambitious target given the background research and various stages it must go through including consultation, independent examination, and Secretary of State scrutiny before it is published.

It was this latter stage that caused the longest delays, with over six months passing whilst negotiations continued between the Mayor and Secretary of State, culminating in a formal response from the Government late last year. It goes without saying that the relationship between a Labour Mayor and the Prime Minister (and former Mayor) and his Conservative Government was never going to be smooth sailing, and the new London Plan process has been a fallout of this tension. But having conceded on several points, as discussed below, the Mayor has finally reached the last stage in formalising his new London Plan.

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London Plan briefing note
February 2021

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