GERALDEVE
A NEWMARK COMPANY

LONDON MARKETS

London office property performance and key themes

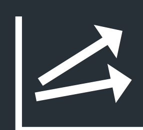
November 2023

Read more

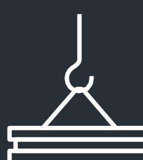
LONDON OFFICE MARKET SUMMARY

Take-up increased to 2.9m sq ft in Q3 2023, which was 30% more than Q2 and 5% above the five-year quarterly average. Most transactions were for high quality accommodation that will meet all EPC regulations to 2030. The development pipeline is strong and pre-letting accounted for nearly a fifth of total take-up.

Mayfair & St James's and the City have relatively resilient demand and restrictive supply at the top end of the market and were the only areas to record an increase in Grade A rents in Q3. The West End is expected to outperform the other segments, though rental growth anywhere will be in low single digits.



The overall availability rate was effectively unchanged at 9.1% in Q3. The uptick in take-up was not enough to offset new refurbishments and developments brought to market. Furthermore, there are signs that availability in some subsectors may increase further through break options on leases signed pre-Covid.



An estimated 1.5m sq ft of new developments completed in Q3 across 11 schemes, bringing the expected 2023 total to 3.8m sq ft. Completion dates slipped with nearly 1m sq ft pushed to Q4, and 0.5m sq ft pushed to Q1 2024. Speculative developments may face further delays on the back of increased financing margins.

Refurbishment and redevelopment activity has increased across central London offices. This is due to the increasing costs of new-build developments and/or requirements to improve the environmental credentials of standing stock.

The volume of investment transactions increased in Q3 and totalled £1.4bn across 29 transactions. This was an increase of 50% on Q2 but still 40% below the 5-year quarter average. Office yields have moved out over 2023 more than any other major property sector and office total return was -14% in September.

2.9m sq ft ▲
Take-up, Q3 2023

9.1% ▼
Availability rate, Q3 2023

£1.4bn ▲
Investment volume, Q3 2023

-14% ▼
Central London offices, annual total return, Sep-23

GERALD EVE LONDON SUBMARKETS

THE LONDON ECONOMY

GVA

	2022	2023	2024
London	6.1%	0.9%	0.6%
UK excl. London	3.5%	0.3%	0.4%

ILO UNEMPLOYMENT RATE

	2022	2023	2024
London	4.5%	4.6%	4.9%

OFFICE-BASED EMPLOYMENT GROWTH

	2022	2023	2024
Central London	6.5%	3.7%	0.1%

Source: Oxford Economics

LONDON FLASH PMI SEPTEMBER 2023

52.4 ▲
Business Activity Index
A three-month high with London the only region to record an expansion.

51.2 ▲
New Business Index
Mixed response from firms, as some recorded a marginal increase in new work, whereas others noted weakened demand.

68.3 ▼
Future Activity Index
Fractional drop on the previous month and just over half of firms expected output to increase in the next 12 months.

48.0 ▼
Employment Index
Reduction in employment for the first time in 2023 following weakened demand and restructuring efforts.

Source: IHS Markit
Arrow indicates monthly change, above 50 signifies expansion

London's PMI data outperformed the other UK regions on most measures, but prospects for growth nevertheless remain modest. A diverse range of responses from firms suggests consumer sectors are dealing with weakened demand, while others report growth in new business.

London's GVA growth is expected to remain positive but the rate for 2024 has been revised down to 0.6% from 1.5% three months ago.

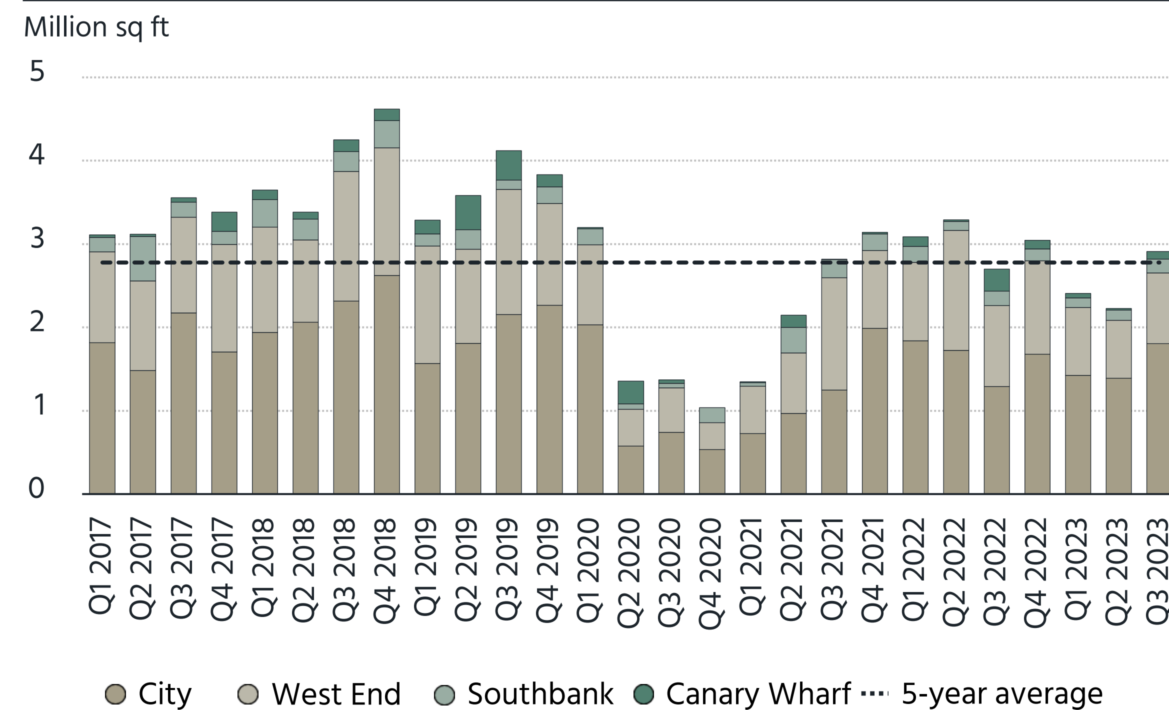
PMI responses on employment point to cost saving efforts through corporate restructuring. Weakened demand has led to job cuts in consumer sectors and will be the main contributor to the increase in the unemployment rate. It is expected to rise to 4.9% in 2024, which is a 0.2%-pts upward revision on the previous forecast.

Office-based employment growth in 2024 is expected to be 0.1%, with minimal growth in real estate and IT sectors. Admin and support is anticipated to be the outperforming segment growth of 0.7%, with the overall figure counterbalanced by a fall of -0.7% in the financial services sector.

DEMAND

London office quarterly take-up by submarket

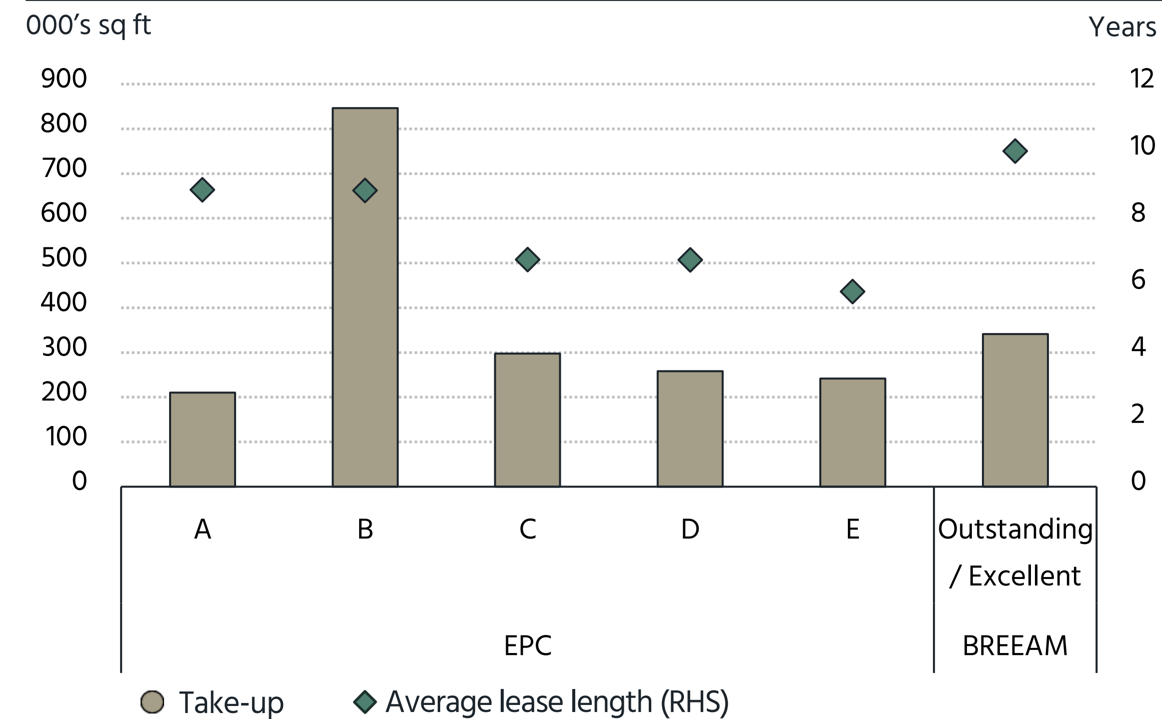
Source: Gerald Eve



After a quiet H1, take-up rebounded with 2.9m sq ft in Q3, an increase of 30% on Q2 and 5% above the 5-year quarterly average. Take-up in the City was 1.8m sq ft, driven by several leases in larger lot sizes, including three over 50,000 sq ft signed in September. Kirkland & Ellis' 170,000+ sq ft pre-let at 40 Leadenhall Street was the largest letting of the quarter. Pre-lets accounted for 22% of City demand in Q3. In the West End, Q3 take-up was just under 850,000 sq ft, an increase of 22% on Q2. Mayfair & St James' demand has stayed consistent throughout 2023, while a threefold quarterly increase in Victoria boosted West End activity in Q3.

Leasing activity by EPC/BREEAM, >5,000 sq ft, Q3 2023

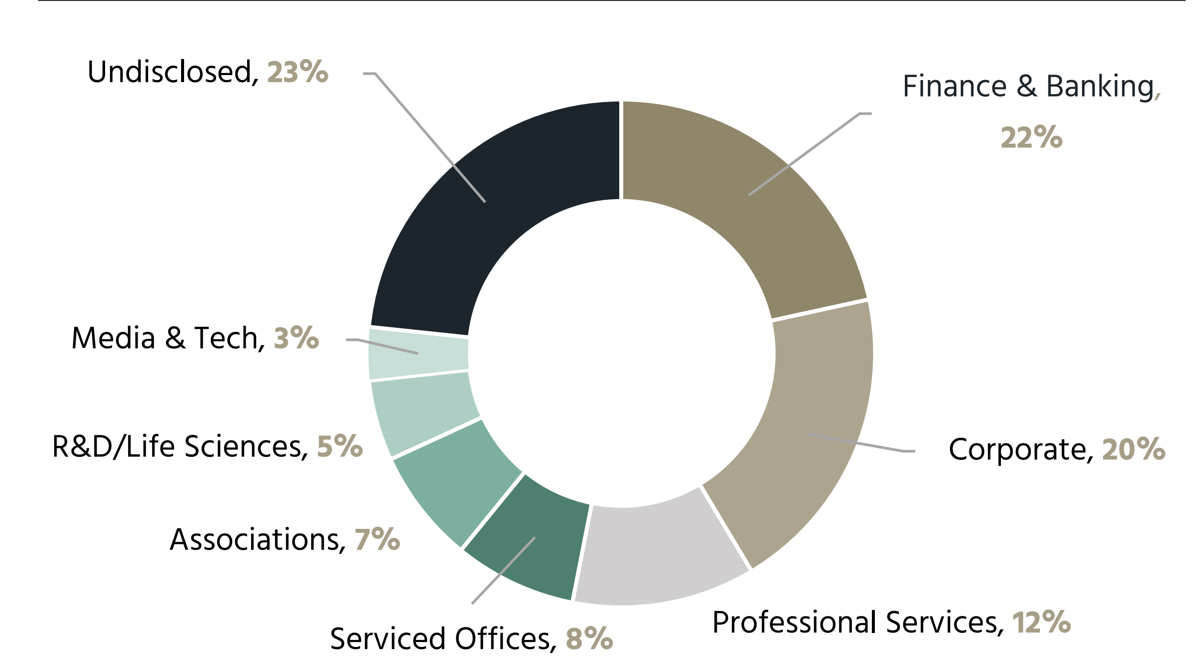
Source: Gerald Eve



Despite ongoing uncertainty around Government commitments to environmental regulation and the path to net zero, occupiers are acting on wider alignment strategies. Nearly two-thirds of take-up over 5,000 sq ft was for offices that will continue to be compliant by the 2030 EPC deadline. The average lease length signed in Q3 showed occupiers will typically commit long term to buildings that will take them up to and beyond the deadline. Offices with the highest environmental credentials secured an average lease length of 9.3 years. Conversely, lower rated (EPC C & D) offices were shorter at 6.8 years, taking these beyond the 2030 deadline but these can't be relet without improvements once expired.

Take-up by business sector, Q3 2023

Source: Gerald Eve

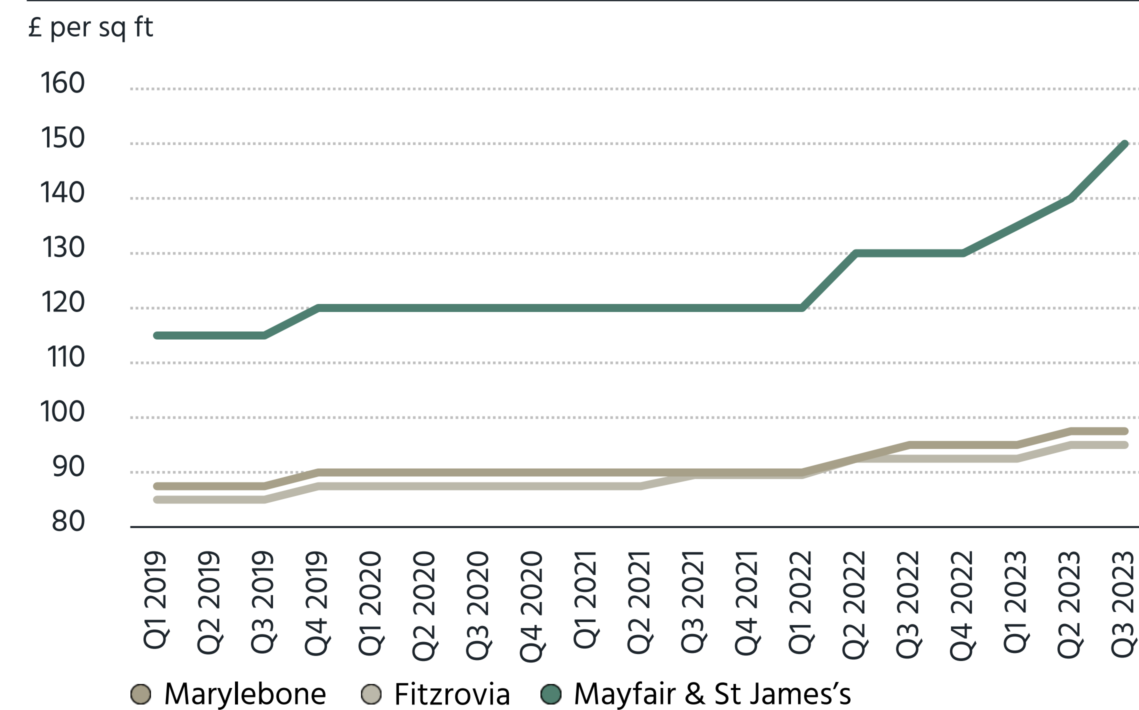


The finance & banking sector took top spot for activity in Q3. In the sector, four of the top five leases were pre-lets over 20,000 sq ft. Insurance companies were notably active, accounting for 17% of demand. Corporate activity was led by John Lewis' 104,000 sq ft lease at 1 Drummond Gate, with a handful of commitments over 20,000 sq ft. Serviced offices recorded two consecutive quarters of demand over 100,000 sq ft for the first time since the end of 2019. WeWork's renegotiation of global leases could offer opportunities for other providers and landlords have launched serviced or flex offices which might increase activity. However, the absorption of forfeited space won't translate into an increase in net demand.

RENTS

Core West End submarkets, Grade A rents

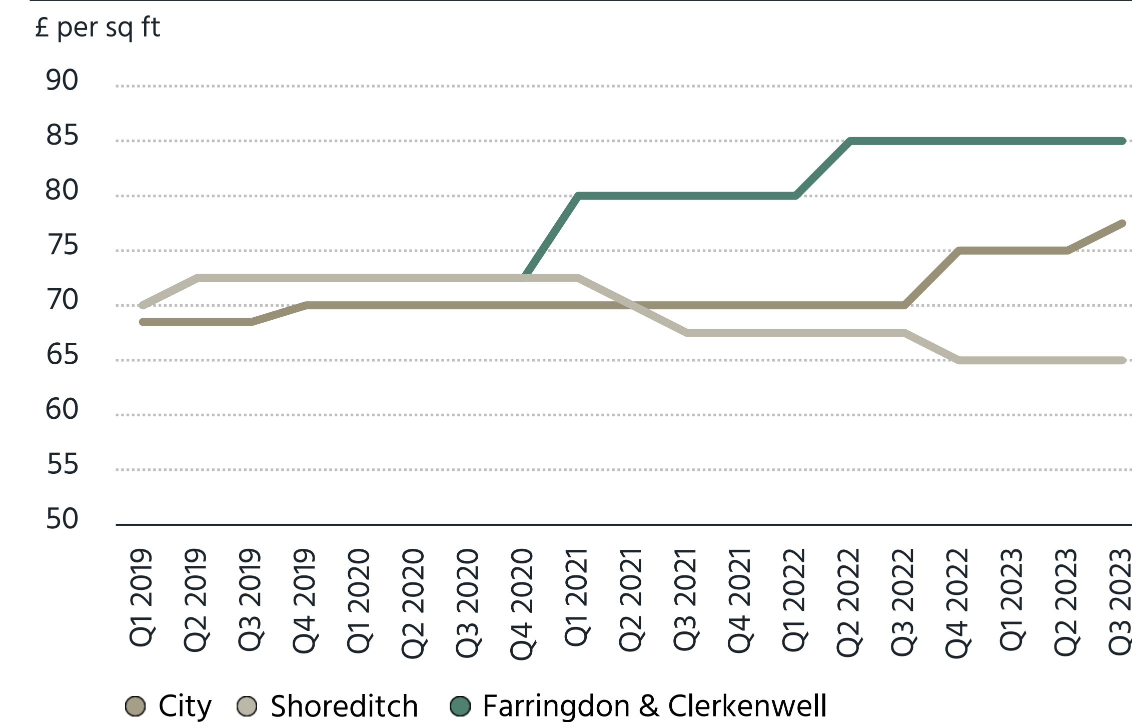
Source: Gerald Eve



Resilient demand in core West End markets has meant availability across these submarkets has fallen markedly and supply is tight at the top end. Demand for Grade A space is particularly strong in Mayfair & St James's from finance and banking occupiers. Nearly 90% of take-up from the submarket's core occupier sector has been in Grade A space over the last three years. Rents here are growing the fastest across any of the tracked submarkets, increasing to £150 per sq ft in Q3, which is 15% higher than a year ago. Available Grade A space here is at a premium, particularly in larger floorplates.

City submarkets, Grade A rents

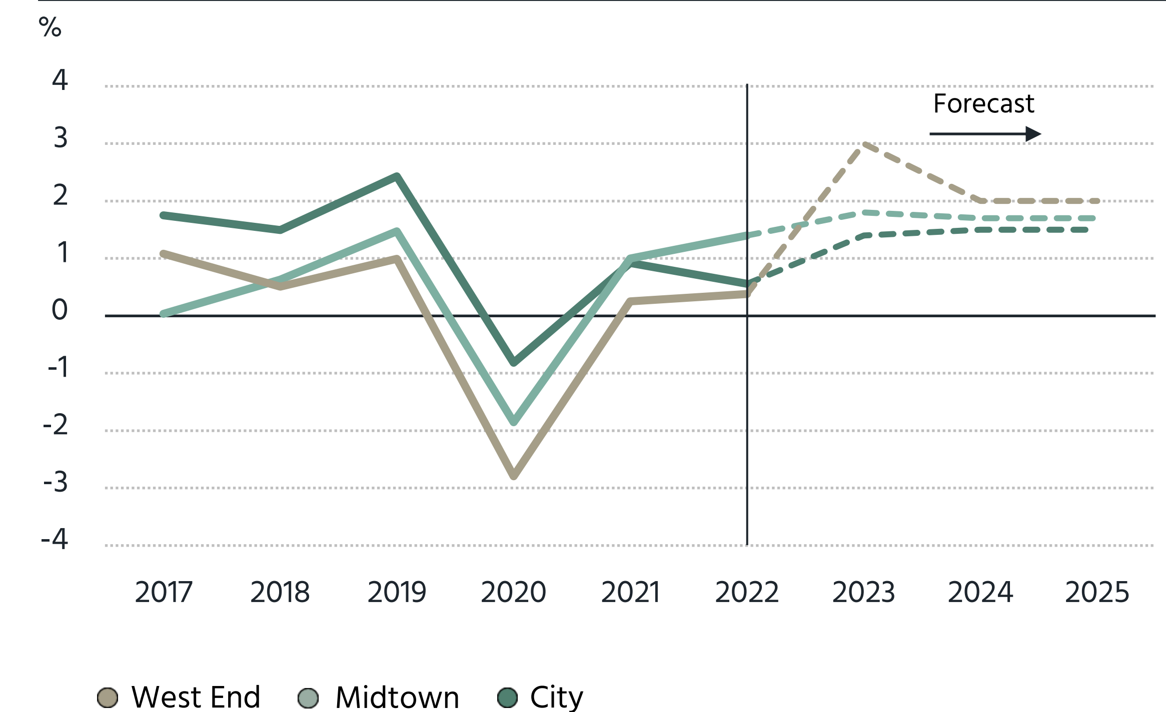
Source: Gerald Eve



However, wider City availability is still high historically and there is a large volume of space under construction. The uptake of pre-lets will dictate future Grade A rental growth. Take-up in Q3 suggests that pre-let activity can be sustained, but if this demand falls and new supply outpaces demand, rental growth will slow. This is the case in Farringdon & Clerkenwell where new deliveries have outpaced demand, with no rental growth over the last year while incentives rose to 24-27 months on a typical 10-year lease last quarter. The City availability list also consists of lots of poorer quality stock that has been available for a long period, which will moderate City rental growth overall.

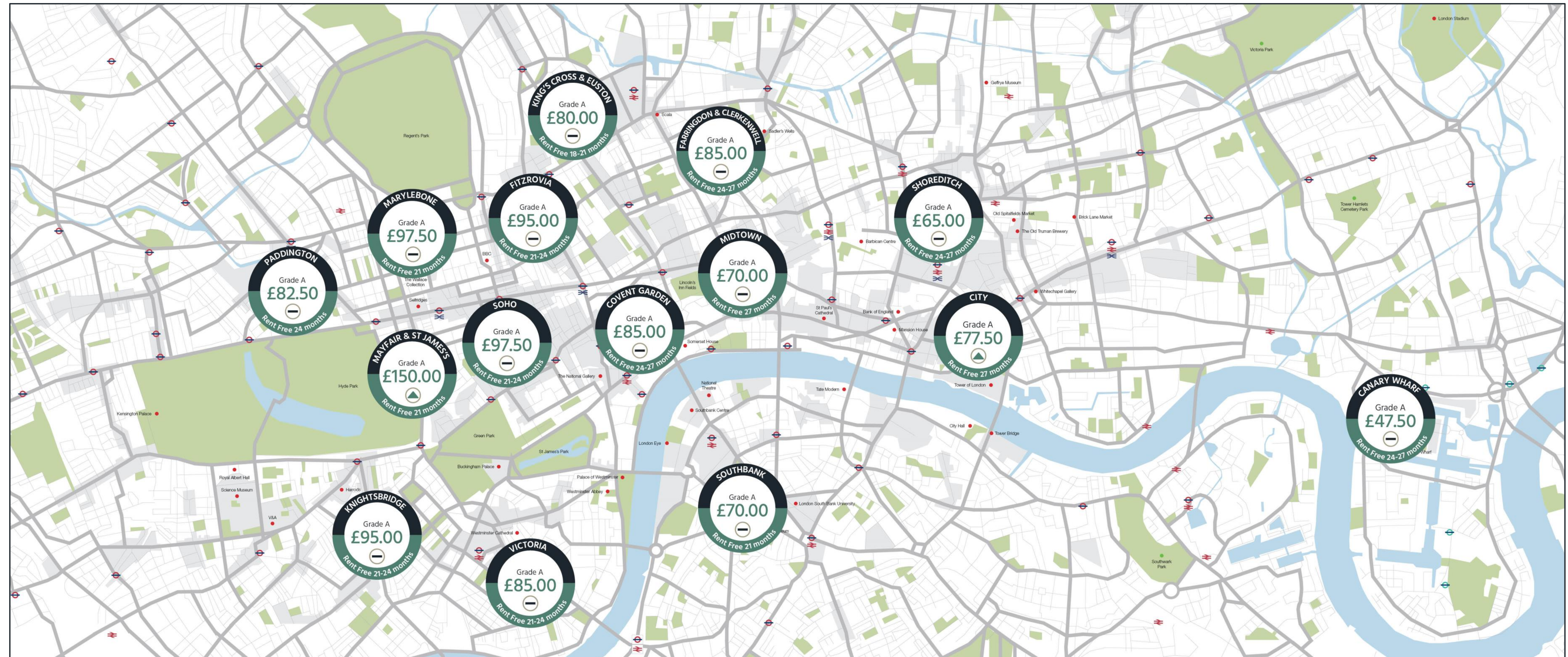
Rental growth forecast by London office segment

Source: Gerald Eve, MSCI



The West End is expected to outperform the other segments, with annual rental growth of 3% in 2023. Space under construction in the West End will fall short of occupier demand and competition will put upward pressure on rents. The City outlook is more moderate, with annual growth averaging 1.5% over the next three years. Prime buildings with large floorplates will be of high interest for new HQ style buildings for big corporate moves in the next few years and drive growth in the top end, but secondary locations with pockets of high availability will underperform. There are new refurbs coming in Midtown, but supply is limited. Rental growth of 1.7%pa over 2023-2025 is expected, with new Grade A underpinning the increase.

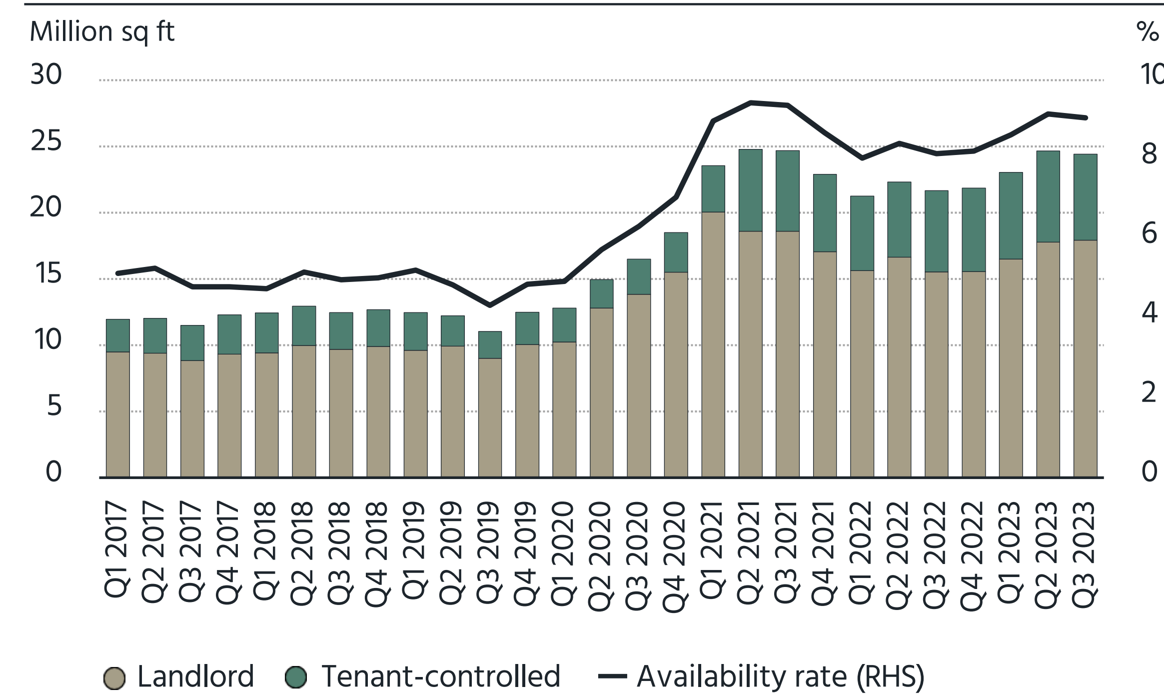
RENTS AND INCENTIVES BY SUBMARKET



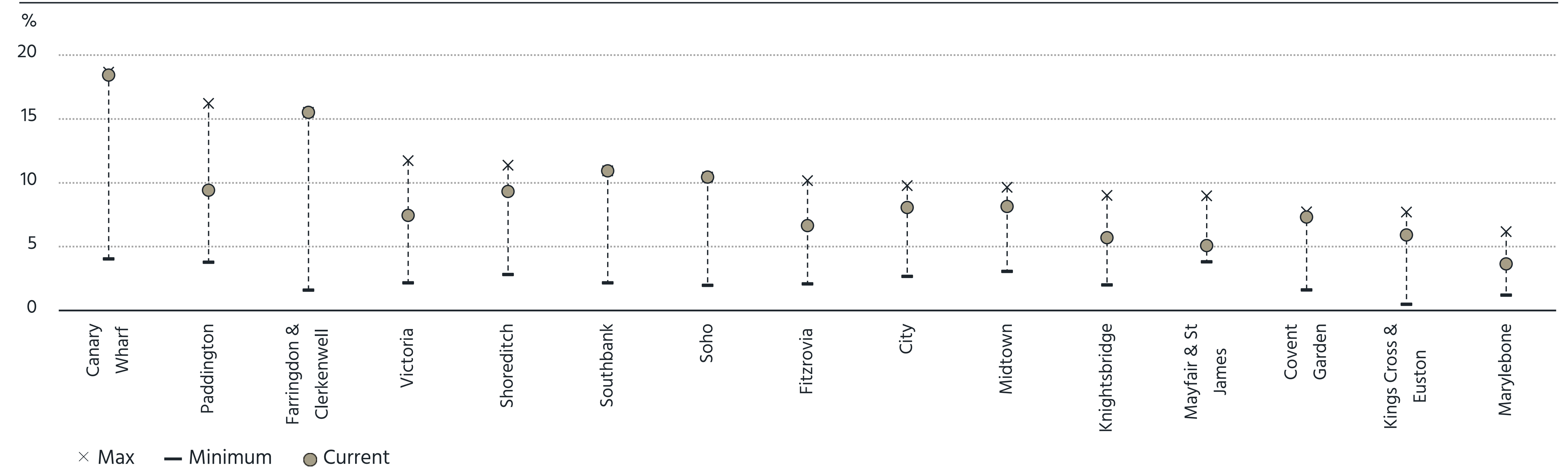
Typical achievable headline rent for 'Grade A' space let on a typical 10-year lease on a mid-level floor with no terrace.

AVAILABILITY

Central London availability by type of listing and rate
Source: Gerald Eve



Availability rate and historical range by submarket, Q1 2013 – Q3 2023
Source: Gerald Eve



The availability rate fell by 0.1%-pts to 9.1% in Q3. The uplift in demand was not enough to offset growth in landlord supply as new refurbishments and developments continue to come forward. Instances of lease exits such as Facebook at Regent's Square, alongside WeWork's ongoing renegotiations in their global portfolio means there are potential availability jumps on the horizon, with WeWork's total occupation in London at 3.3m sq ft. The company exited 133 Houndsditch and evicted tenants, and the investment arm Ark has been active selling in the last 12 months. Fitch's recent downgrade in credit rating and exits in US markets which are underperforming could be replicated in the UK.

WeWork's largest occupation is in the City (1.3m sq ft) however, if released, availability would not go above the submarket's peak reached in the pandemic. Other submarkets with large exposure include Southbank (350,000 sq ft), Farringdon & Clerkenwell (340,000 sq ft), and Canary Wharf (285,000 sq ft). The locations, where availability is near to or at the historical peak, will face further downward pressure on rents in Grade B and secondhand stock if an influx of availability comes online. However, core West End submarkets have little exposure to this issue. Covent Garden, Soho, Victoria and Marylebone all have less than 110,000 sq ft of WeWork occupancy, with none in Mayfair or Fitzrovia.

As time passes, occupiers that signed pre-Covid in 2018 and 2019 that have an upcoming break may be more likely to exercise it and change occupation strategies. In total, we estimate nearly 2.5m sq ft is up for break between now and the end of 2024. By size band, leases in the range of 5,000 – 10,000 sq ft are the most common, followed by 10,000 – 20,000 sq ft, but little to note over 50,000 sq ft. Downsizing has been common in new leases as occupiers adjust to remote work which means some of this space will likely come back to market. Office-based employment will be weak this year, with some sectors expecting to reduce headcount, which could lead to further exits or downsizes.

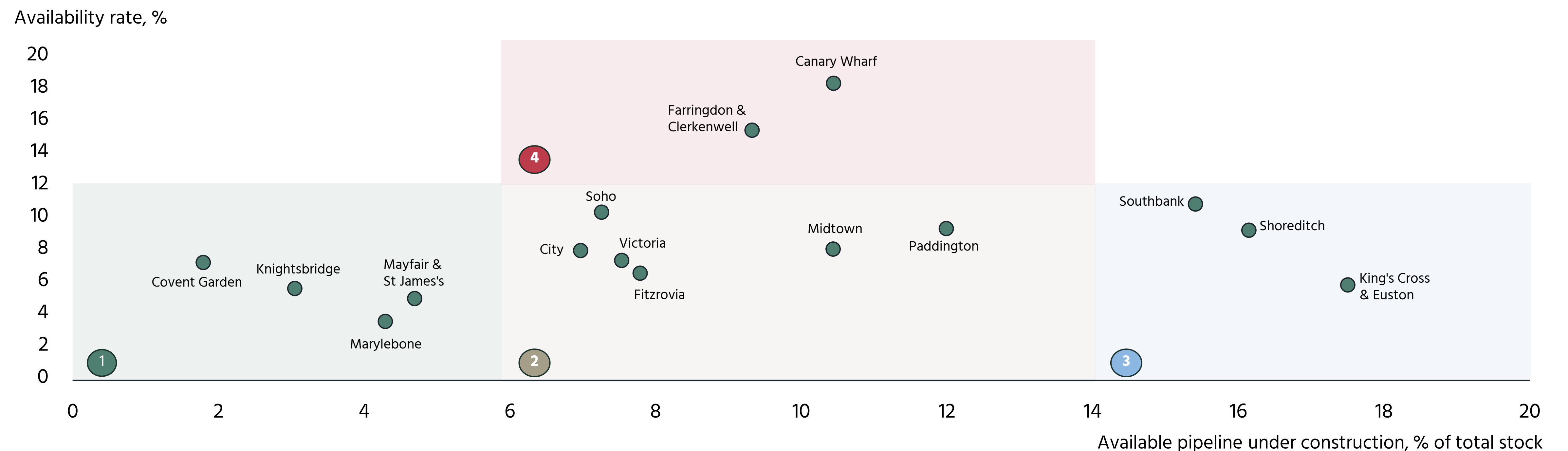
DEVELOPMENT

London office development pipeline, new builds

Source: Gerald Eve

Availability and development (viability of refurbishment)

Source: Gerald Eve



An estimated 1.5m sq ft completed in Q3 across 11 schemes, with several cited for end-Q2 delivery falling into Q3. The total completion volume so far in 2023 is now just under 3.8m sq ft. In Q4, an estimated 3.6m sq ft is set to complete, with nearly 55% of this pre-let. Most of the pre-leasing is in KGX1 and 21 Moorfields, Google and Deutsche Bank's new respective HQ's. Several schemes cited for Q3 delivery have been delayed until Q4, totalling nearly 1m sq ft, while nearly 0.5m sq ft has fallen into Q1 2024. Bayes data from mid-year 2023 show development finance margins for spec developments moved out 32bps on average from end-22. So, while the SONIA debt benchmark moved in slightly, it has been offset by the increase in perceived risk of development from lenders.

Refurbishment and redevelopment activity has increased across central London offices. This is due to the increasing costs of new-build developments and/or requirements to improve the environmental credentials of standing stock. Existing availability and available pipeline is a key determinant of which submarkets are best positioned for refurbishment. Those with low availability, a small pipeline as well as poorly EPC rated stock should be a key focus for investors or landlords willing to take on sustainability linked refurbs. On the other end of the spectrum, there are cases where use changes might be more appropriate. A handful of recent bids on offices have had hotel conversions in mind, and there is a case for student accommodation and other PRS uses.

1. Prime for refurb – submarkets with low availability and limited pipeline to absorb demand

2. Select refurb opportunities dependent on pipeline and existing sustainability credentials

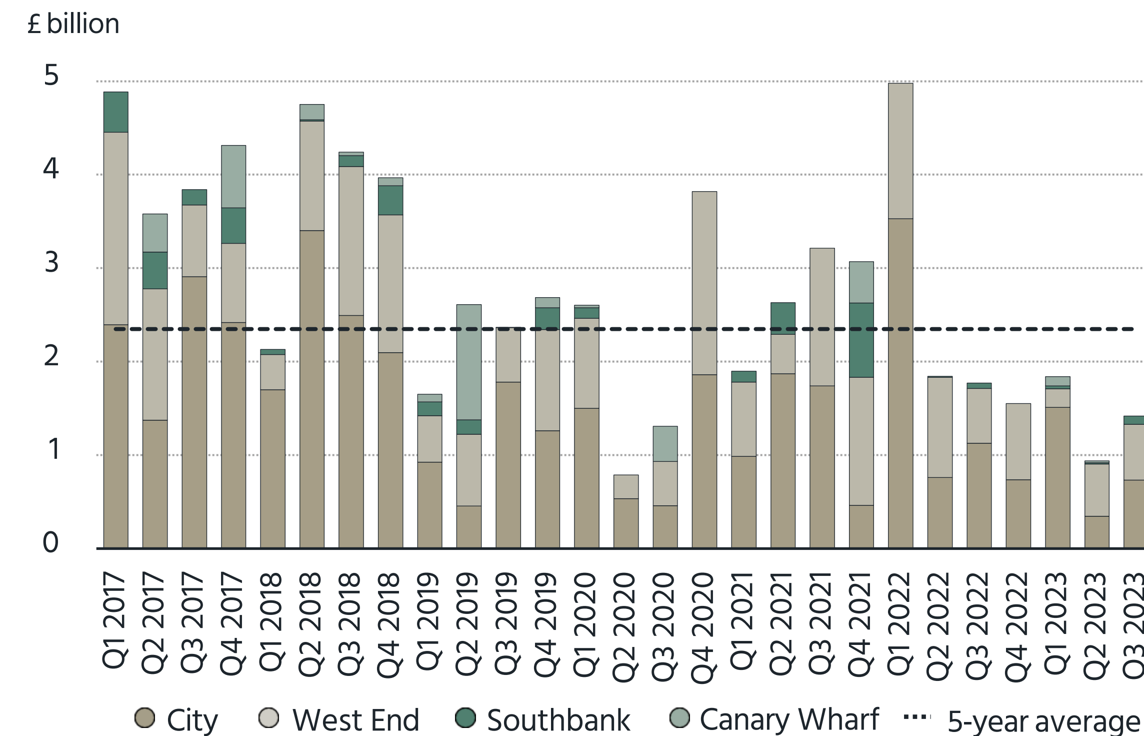
3. Recently developed submarkets, newer office stock & less suited for refurb

4. Limited immediate refurb potential; high availability, possible use changes

INVESTMENT

Quarterly investment volume by broad market

Sources: Gerald Eve, Real Capital Analytics



The volume of investment increased in Q3 and totalled £1.4bn across 29 transactions. This was an increase of 50% on Q2 but still 40% below the 5-year quarter average. The relatively low average deal size of £48m in Q3 was consistent with Q2 and reflects the ongoing difficulty in raising debt for larger acquisitions. Investors have shifted their focus to smaller lot sizes, with nearly three quarters of investments in Q3 under £50m. Bloom in Farringdon and Clerkenwell was the largest investment in Q3, acquired by a UBS private client for £240m from HB Reavis.

On the buy-side, overseas investors were the most active with acquisitions totalling £735m across 12 transactions. A private Vietnamese investor's purchase of Lion Plaza for £209m was the largest acquisition in Q3. North American investors continue to be active, looking for value in London offices versus domestic markets which have been hit harder on vacancy and pricing. UK property companies were the second most active with acquisitions totalling £326 across nine transactions.

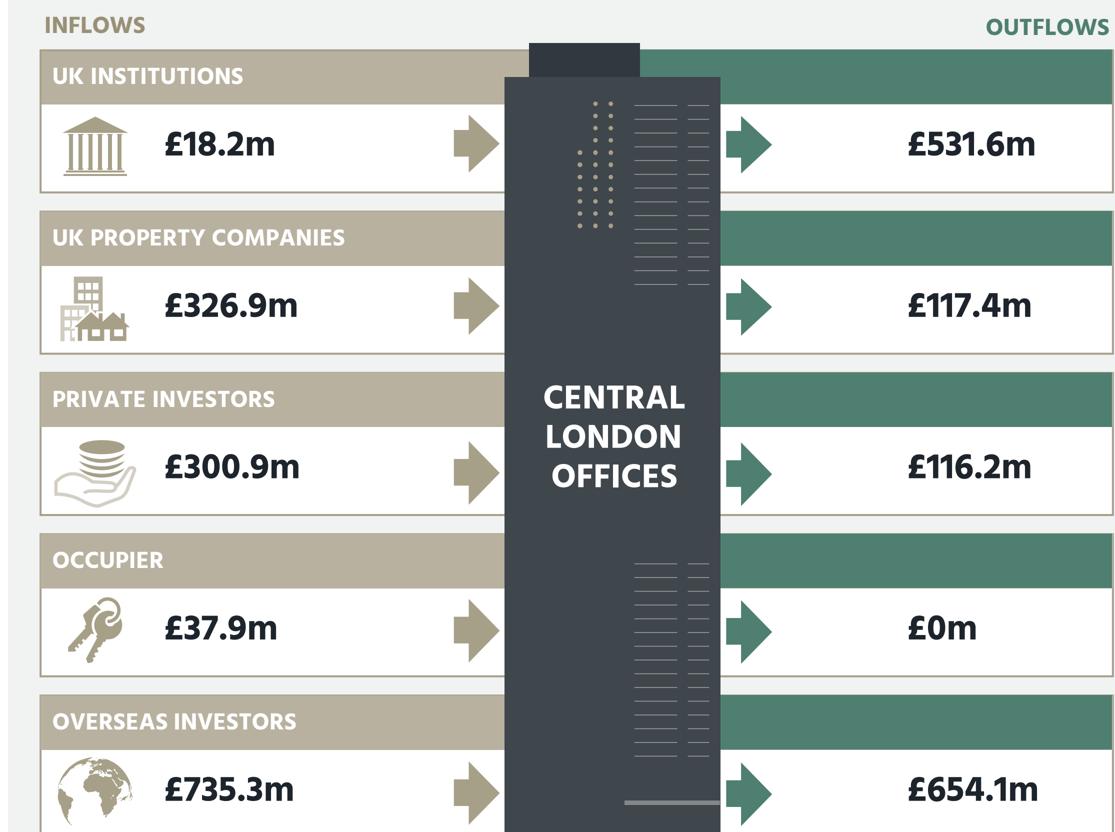
On the sell-side, overseas investors were most active, with £654m disposed across nine transactions. European investors divested the two largest lots for a total of just under £450m in Q3. UK institutions were also active, with outflows of £531m mostly on small lot sizes.

Price and availability of debt is one of the limiting factors in the investment market. Indications from the BoE are that interest rates may have peaked but there is a small possibility of further hikes, with upcoming inflation and employment data set to be closely scrutinised. The SONIA forward curve suggests future interest rates will be in a "tabletop" shape, staying at 5% until end 2024, before starting to fall in early 2025.

Bayes' mid-year 2023 report cites lender appetite for secondary offices fell markedly, with only a third willing to provide loans. In contrast, nearly 90% were willing to lend on prime. All-in equity purchases from well capitalised investors (such as UK prop co's which divested well in 2021/22) will be a common theme over the next 6-12 months, given ongoing challenges in debt market.

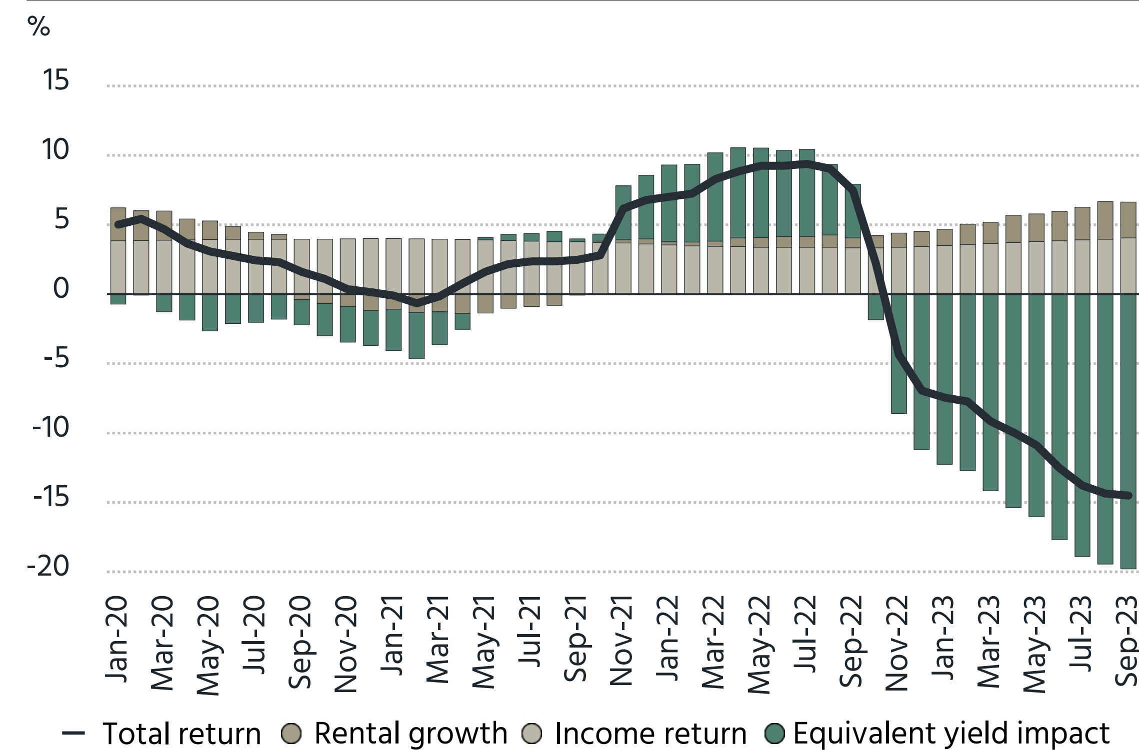
CENTRAL LONDON OFFICE CAPITAL FLOWS, Q3 2023

Sources: Gerald Eve, Real Capital Analytics



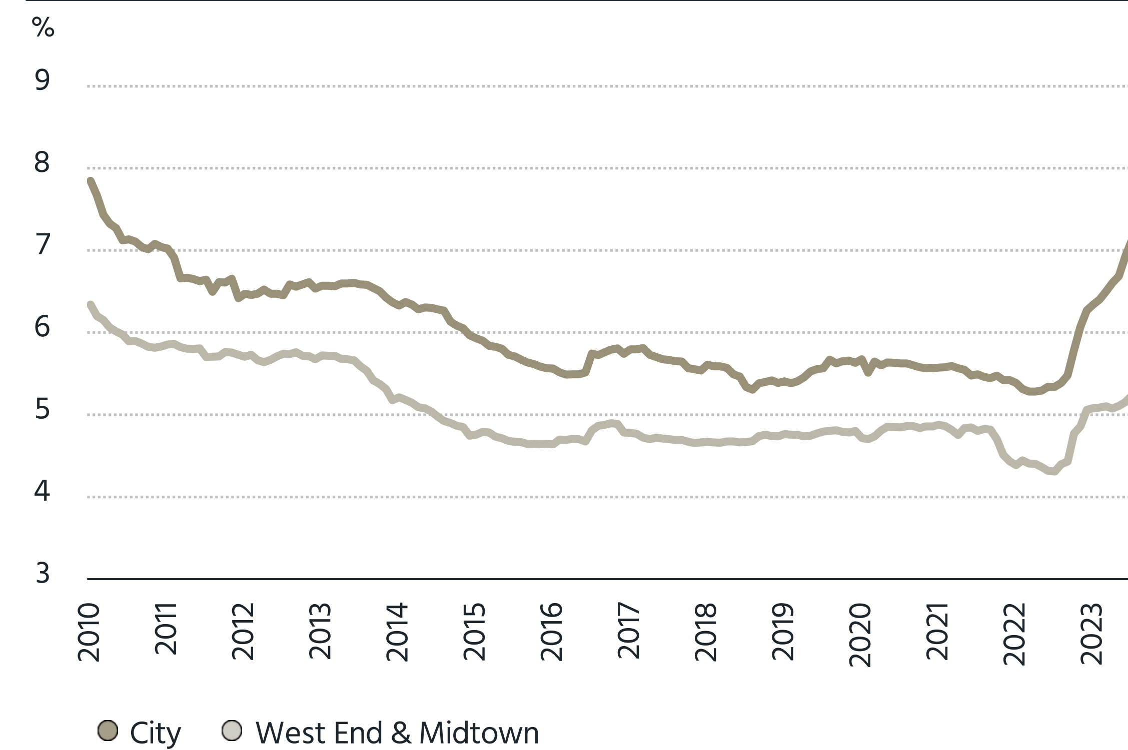
WHERE NEXT FOR OFFICE YIELDS?

Annual total return and components, Central London offices
Sources: Gerald Eve, MSCI



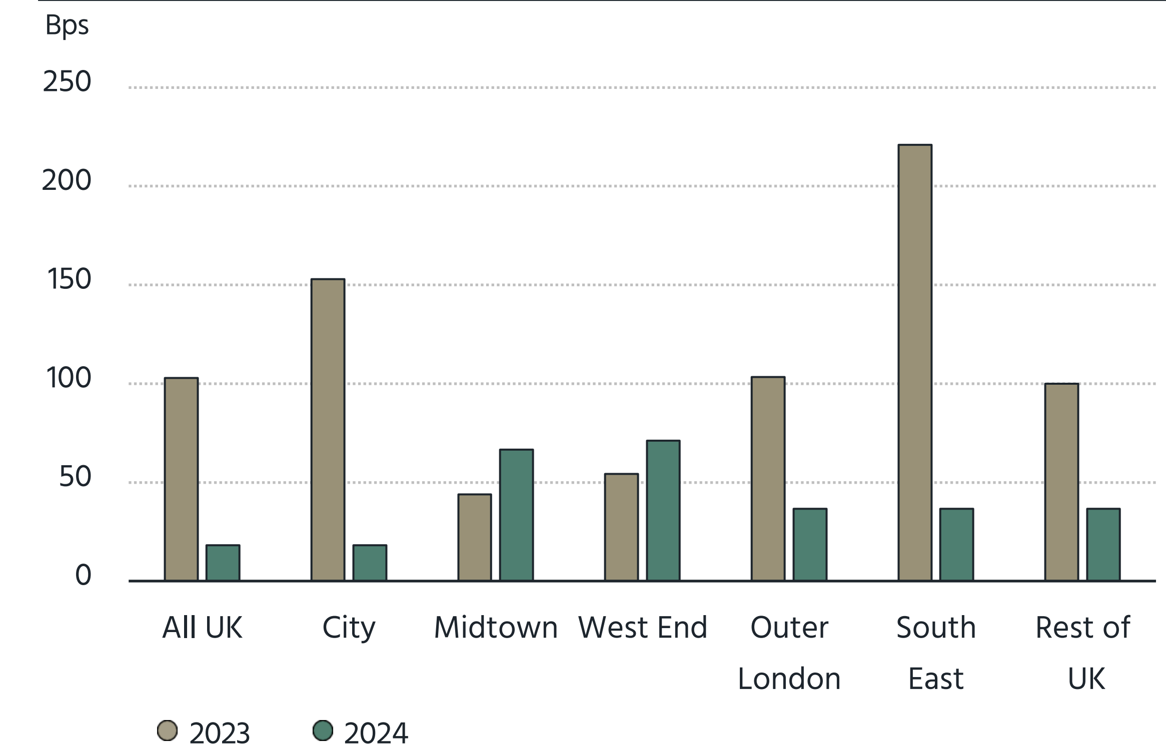
Recent MSCI data for Central London reflect challenges in office valuations after shifts in the debt market and structural changes in office use. Positive rental growth and consistent income return did little to offset the annual equivalent yield impact of -20% in September, producing an annual total return of -14%. Assets with short or poor income are undergoing a sharp repricing. This reflects the capex required to refurbish lower quality offices and/or the additional reletting risk for buildings with vacant possession or short income.

Equivalent yield by London office segment
Sources: Gerald Eve, MSCI



Office yields have moved out over 2023 more than any other major property sector. City offices has been the most significantly affected segment, moving out 120bps to 7.5% between December 2022 and September 2023. This was the highest recorded City office equivalent yield since early 2010, and some further softening is anticipated over the remainder of 2023. Outward yield shift in early 2024 will be influenced by the interest rate trajectory and is expected to top out at 7.8% in early 2024, with City yields remaining broadly flat for the remainder of next year.

Forecast equivalent yield shift by UK office segment
Sources: Gerald Eve, MSCI



West End yields were mostly stable in H1 but moved out in the three months to September. The equivalent yield for the combined segment was 5.3%, a movement out of 30bps since the end of 2022. The occupier market in the West End is more positive which meant investor interest has upheld better compared to other locations. However, the current spread of 70bps between West End & Midtown yields and the 10-year gilt, is at its lowest barring the GFC and the month after the mini-budget. The spread will widen over the next 3-6 months, with West End yields expected to peak at 5.6% as the “tabletop” shape for interest rates and bond yields means investors seek an increased margin over the risk-free rate.

GERALD EVE IN THE MARKET

RECENT LETTINGS

86 Jermyn Street, SW1

Acting on behalf of Royal London Asset Management we have successfully completed a hat trick of new leasing deals during Q3 totalling 10,000 sq ft, with rents achieved of £107.50psf.

Please contact Rhodri Phillips, Patrick Ryan or Viviana Thurstan for more information.

210 Pentonville Road, N1

Acting on behalf of Global Holdings, we have exchanged contracts to lease 10,400 sq ft over the 1st floor to Norwegian cruise liner Hurtigruten.

Please contact Rhodri Phillips, James Lunn or Amy Bryant for more information.

ACTIVELY MARKETING

The Pulman, 20 Thayer Street, W1

On behalf of The Howard de Walden Estate, we will shortly be launching a brand-new office and retail development in the heart of Marylebone, comprising 18,000 sq ft of premium grade offices over Levels 1 to 4.

Please contact Rhodri Phillips or James Lunn for more information.

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FURTHER INSIGHTS

In Brief
October 2023

Multi-let
July 2023

Prime Logistics
Q3 2023

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