

Current Issues Note 27

Central London office market through the recession

By **Yeukai Muchenje** and **Nick Ennis**



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For more information about this publication, please contact:

GLA Economics

telephone 020 7983 4922

email glaeconomics@london.gov.uk

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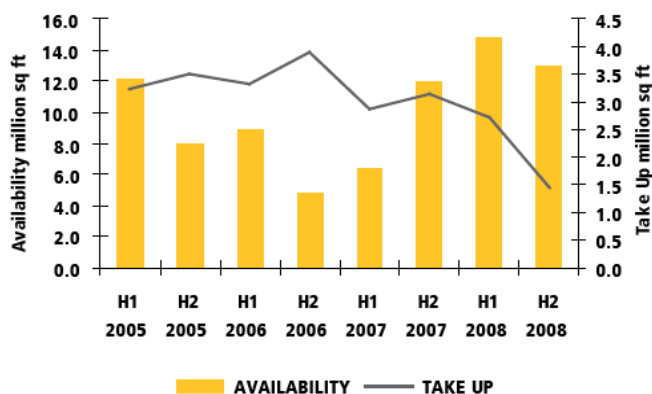
This note reviews the impact of the recession on Central London's office market. During the recession, the market experienced falling demand and an increase in the vacancy rate. After rising until 2007, rents fell rapidly and investment volumes declined, falling below the long-term average. Today, the market shows signs of recovery as demand has picked up firmly and vacancy rates are now falling sharply, particularly for Grade A space. Prime rents are stable or rising in all sub-markets and investment volumes have started to increase, mainly from overseas investors. Forecasts expect rental growth to continue, as availability is limited. Because developers were quick to put developments on hold at the start of the recession, it is now forecast that a brief shortage of available space is likely over the next few years before renewed investment yields greater supply.

Introduction

In 2007, the UK suffered from a global financial crisis and in the following year entered its deepest post-War recession. The impact of the downturn on Central London's office market began to show quickly and by 2008 the severity of the recession became clear and the office rental market suffered from a sharp drop in demand for office space. In Central London take up levels fell 60 per cent on 2007 and were at the lowest level in over five years as demand from the financial and business service sectors dropped.¹ The Docklands market was the only exception to this, though only because of an exceptional pre-sale announced by JP Morgan for a new European headquarters.

As demand fell, availability increased by 10 per cent across Central London, though by more in some submarkets.² In the City sub market, availability peaked in the middle of 2008, as shown in Figure 1, while in the West End availability continued to rise through 2008, as shown in Figure 2.

Figure 1: Availability and take up in the City

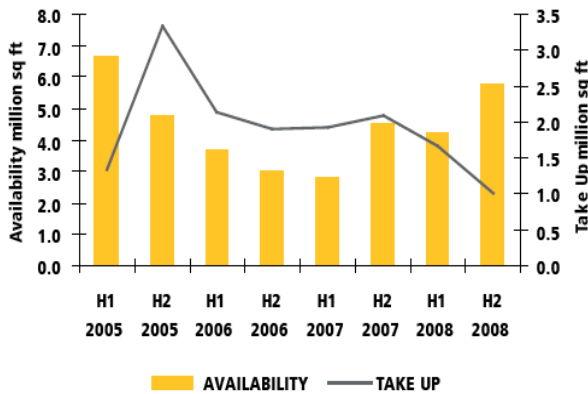


Source: CoStar group

¹ CoStar, Central London Office Market Review, 2008.

² Ibid.

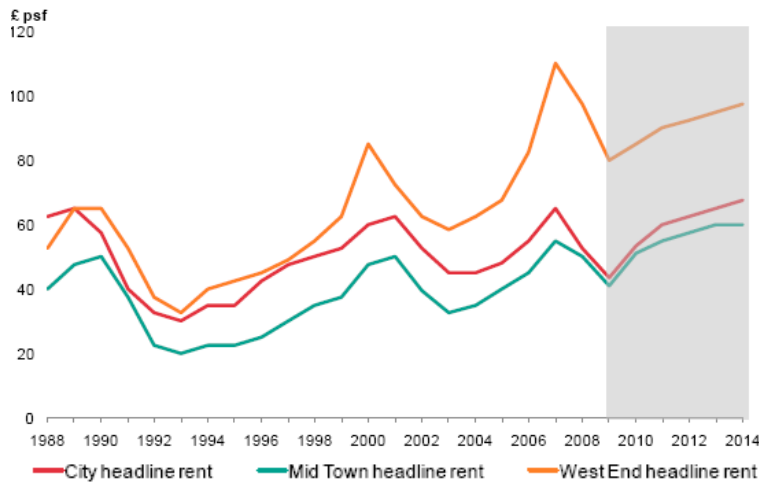
Figure 2: Availability and take up levels in the West End



Source: CoStar group

Prime rents had risen sharply from 2005 through to the end of 2007 as the market cycle peaked, but reversed quickly as the recession set in, as shown in Figure 3. The speed of adjustment was quick as developers suspended many schemes and demand from financial services actually remained relatively resilient (partly due to mergers and acquisitions of distressed firms).

Figure 3: Central London prime headline rental growth



Source: DTZ

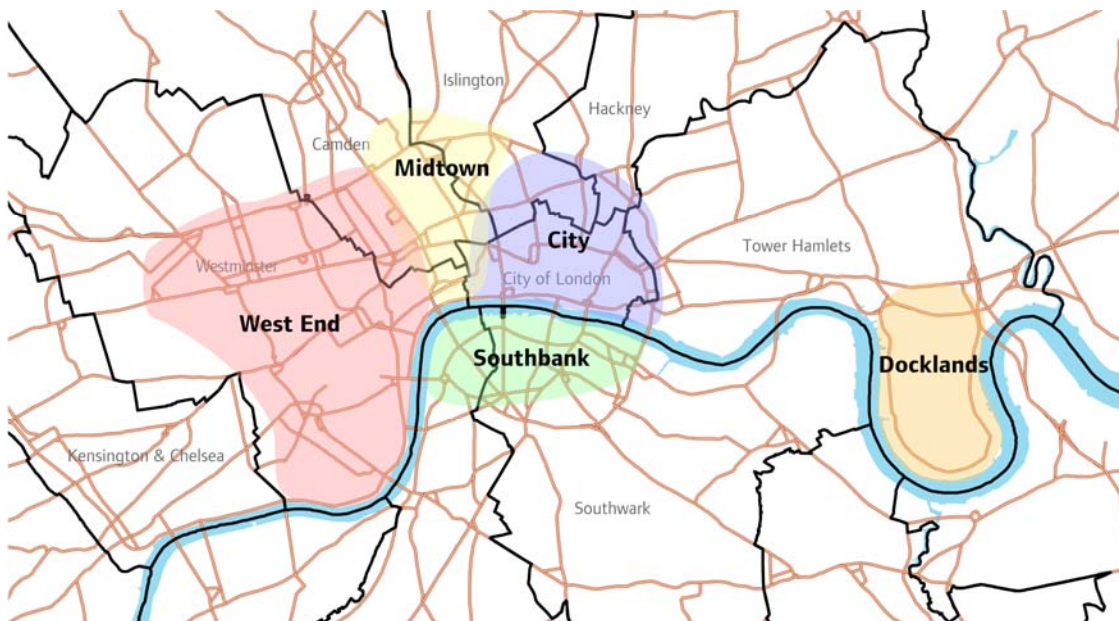
This note will review current conditions in the Central London office market using the latest quarterly reports published by property analysts and survey market forecasts for the near future.

Central London market overview

Central London contains the majority of office space in London, particularly of the highest quality. The main submarkets are the City, West End, Midtown, Canary Wharf and Southbank as shown in Figure 4.³ The City and West End are the core submarkets and account for a substantial portion of the market.

³ Property analysts use somewhat different geographies for each of these areas, with some analysts focussing only on the main City and West End markets and others combining some. Most of these also differ slightly from the definition of Central London used by the Greater London Authority in its Office Policy Review. Figure 4 shows a general indication of the different markets.

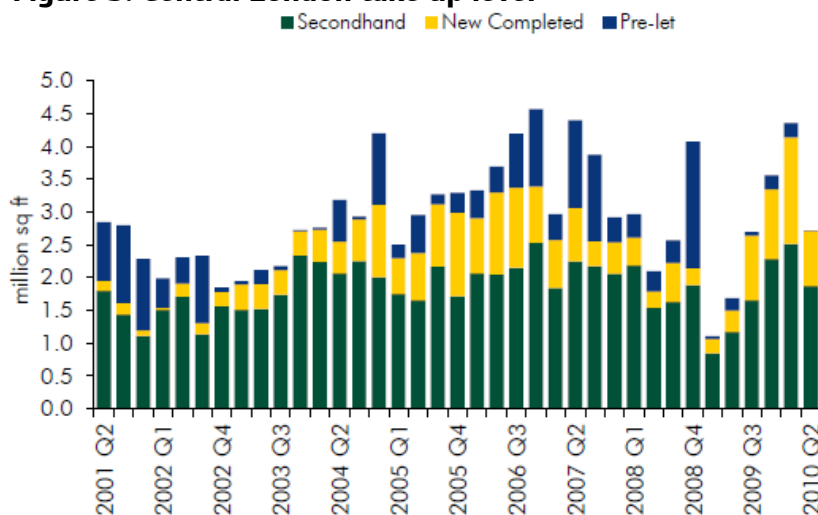
Figure 4: Indicative map of Central London office submarkets



Source: GLA Economics

The Central London office market has begun to emerge from recession, though instability remains present in the market. Demand for office space has picked up firmly in recent quarters. In the first quarter of 2010, take up levels were strong and higher than in any quarter since the peak of the market, as shown in Figure 5. However, take up levels fell in the second quarter across Central London by 37 per cent.⁴ The West End and the City accounted for 41 per cent and 36 per cent, respectively, of take up in the second quarter of 2010.⁵

Figure 5: Central London take up level



Source: CB Richard Ellis

Prime rent levels have recently improved in the City and Midtown submarkets and remain stable in the others. This is mainly due to supply shortages, which is reflected in falling

⁴ Jones Lang LaSalle: Onpoint Central London market Second Quarter 2010, July 2010.

⁵ CB Richard Ellis, MarketView Central London offices, Q2 2010.

vacancy rates in all submarkets. Across Central London vacancy rates were 7.6 per cent in the second quarter of this year, down from 8.1 per cent in the first quarter (Grade A also fell to 3.8 per cent from 5.1 per cent).⁶ The Southbank submarket has the lowest vacancy rate and the Docklands has the highest. Availability in Central London stands at its lowest since the recession began. New developments have begun in the West End, in the City and Midtown.

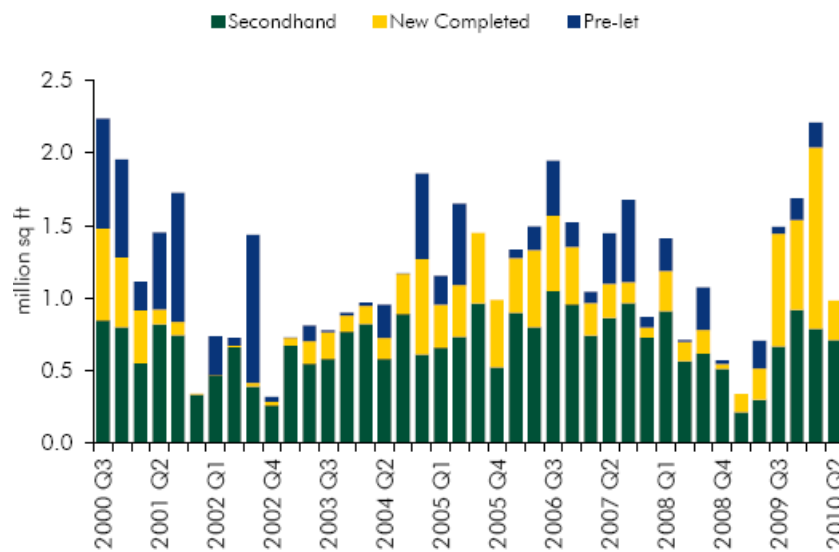
Submarket performance

The following paragraphs will examine each of the Central London sub markets. Information is sourced from CB Richard Ellis to facilitate comparison between submarkets because of the geographical differences amongst the different analyst's reports.

The City

Take up levels in the City bounced back very strongly from the second half of 2009, though have fallen in the second quarter of this year, as shown in Figure 6. Second-hand space accounted for the bulk of quarter two activity, reflecting a limited development pipeline which is expected to fall further in the short term, as shown in Figure 7.

Figure 6: City take up levels



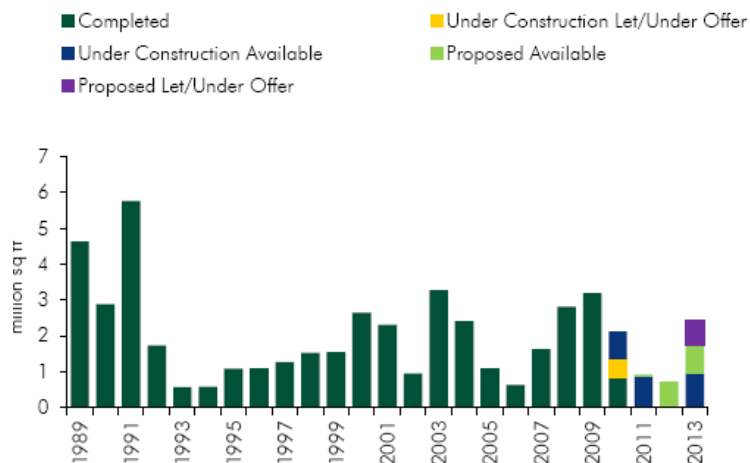
Source: CB Richard Ellis

Only one scheme was completed in the last quarter: Riverbank House, EC4. Developers are looking at options for potential schemes in the City, including restarting those schemes put on hold as the recession took hold. Land Securities and British Land have recently announced plans to restart construction on two towers in the City, reaching 36 and 48 storeys, respectively.⁷ However, buildings take time to construct and so these schemes will not come to market until 2014. Availability in this market is diminishing while prime rents have risen from £47 per sq ft to £50 per sq ft.

⁶ Jones Lang LaSalle: Onpoint Central London market Second Quarter, July 2010.

⁷ Financial Times, "City skyscrapers get the greenlight," 23 October 2010.

Figure 7: City development pipeline

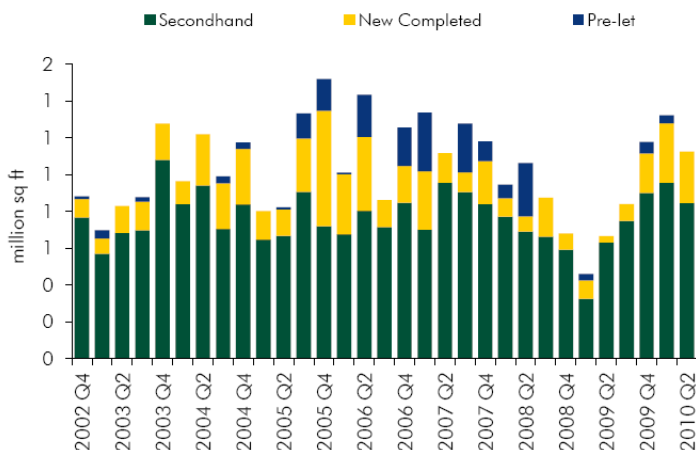


Source: CB Richard Ellis

The West End

The West End market has also bounced back in 2009 and 2010, performing better than expected as demand for office space picked up steadily, particularly for high quality space. The market has been sustained by the global demand for West End offices. Take up levels remained strong in the second quarter of 2010, even though they fell from the previous quarter, as shown in Figure 8. The vacancy rates fell this quarter as availability tightened. Prime rents are stable, following strong growth in the first quarter.

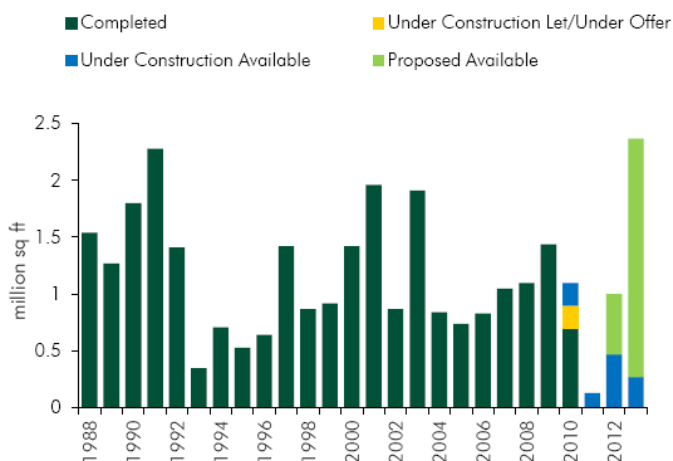
Figure 8: The West End take up



Source: CB Richard Ellis

As elsewhere, there are few anticipated development completions in the rest of 2010 and next year, with the largest scheme still to be completed this year Carmine Merchant Square in Paddington, though this is only 257,000 sq ft (for comparison, 30 St Mary's Axe, "the Gherkin," is 516,000 sq ft). After these developments are complete, there is little in the pipeline until 2012/13, and even much of this is still only in the planning stages, as shown in Figure 9.

Figure 9: The West End development pipeline

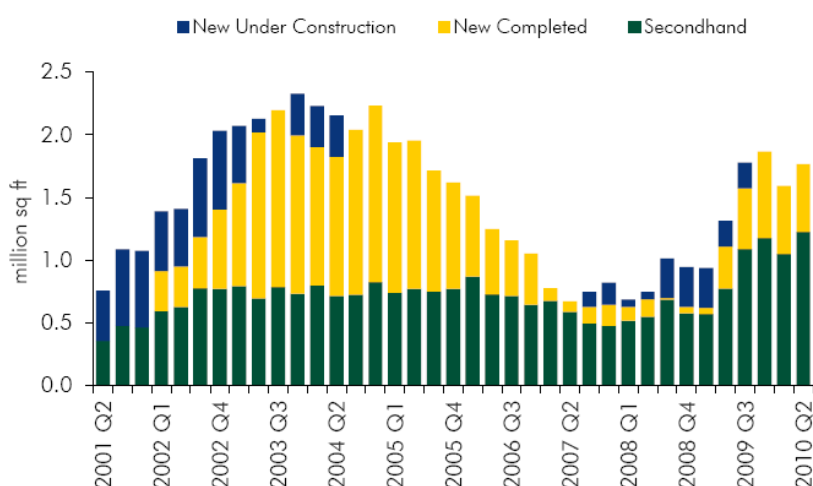


Source: CB Richard Ellis

Docklands

Improvements in financial sector confidence drove take up in the first quarter of 2010, but take up fell back in the latest quarter. Prime rents remain stable and availability increased slightly from the first quarter, as shown in Figure 10. The Docklands market has the highest vacancy rate of the Central London submarkets and there has been a significant rise in the amount of second-hand space available as tenants have adjusted occupancy levels to reflect reductions in staff. The available stock in the Docklands market is unique in that it is mostly of Grade A quality. Some uncertainty remains in this market. There has been speculation that JP Morgan’s ambitious plans for a new £1.5 billion headquarters in Canary Wharf would not go ahead since the deal was announced. The sale contract contains an option for the bank to pull out by the end of 2010 so this uncertainty will be resolved shortly.

Figure 10: Docklands availability



Source: CB Richard Ellis

Midtown

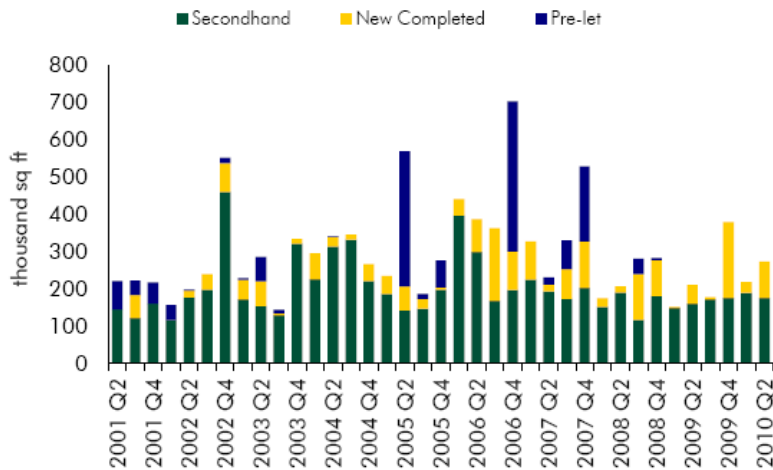
The Midtown market sits between the dominant City and West End markets. This market was not as heavily affected by the recession, in terms of take up, and there was a modest rise in

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take up in the second quarter of 2010, as shown in Figure 11. As in other markets, vacancy rates remain unchanged from the previous quarter and prime rents rose in the second quarter from £47 per sq ft to £48 per sq ft. Availability in Midtown fell 18 per cent from the first quarter, reaching 1.7m sq ft. There are very few schemes in the development pipeline in Midtown. Though the second quarter of 2010 saw the completion of nearly 300,000 sq ft of space, there is only one relatively small scheme under construction for delivery in 2011, which will bring 105,000 sq ft to the market.

Figure 11: Midtown take up

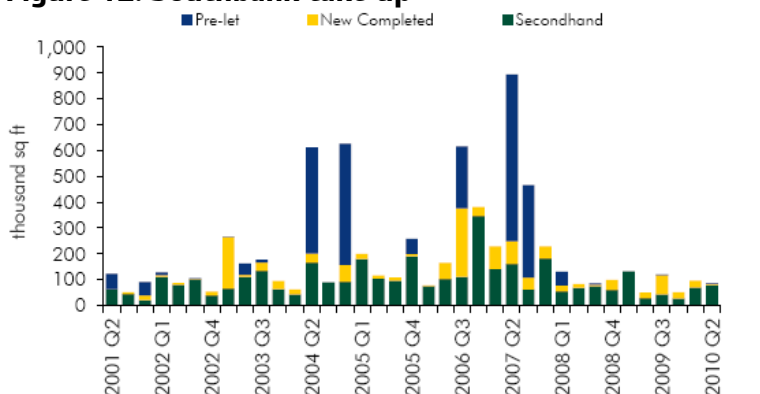


Source: CB Richard Ellis

The Southbank

The Southbank market is a small submarket that has been led by very large schemes in the past. Because of significant pre-letting and a somewhat “lumpy” development pipeline this submarket has not seen as much volatility. Prime rents in the Southbank remained unchanged in the second quarter of this year and this submarket enjoys the lowest vacancy rate across Central London. The low, steady take up in recent quarters is not out of the ordinary for this market, as shown in Figure 12, and given the nature of development here most lease activity was in the second-hand market. Looking forward, the market will see very little new office development until the completion of the Shard at London Bridge in 2012.

Figure 12: Southbank take up

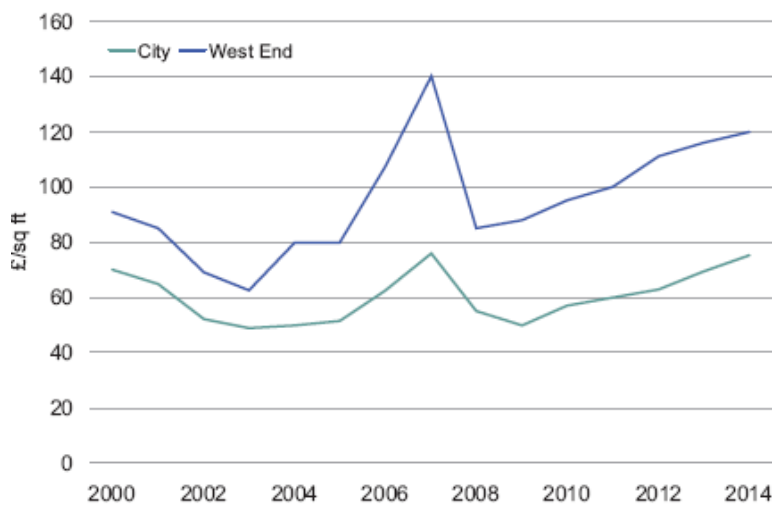


Source: CB Richard Ellis

Summary and forecasts for the future

Overall, the Central London office market was greatly affected by the global crisis that emerged in 2007. It was in 2008 that the Central London commercial property market suffered the effects most. Take up levels dropped across all sub markets and availability increased. Prior to the recession, the property market had seen strong growth and increases in rent levels. However, during the recession the surplus of supply and limited demand caused rents, and investment, to fall. In 2010, the Central London market showed signs of recovery as demand picked up firmly. As a result, take up strengthened and prices have stabilised or risen in all submarkets.

Figure 13: Forecast Grade A rents, City and West End markets



Source: Savills

In 2010, London's office market has bounced back as all submarkets are starting to show signs of recovery. Demand has increased steadily, while supply in all sub-markets is limited. Availability has tightened while vacancy rates fall. As a result, most submarkets are experiencing rental growth, which should make new development likely. The first quarter of 2010 saw the strongest take up levels since the recession, with second hand space accounting for most space taken. This reflects a limited development pipeline. As the market has become tight with high rental prices, we are likely to see an increase in development of new schemes.

Despite the recession, the long-term demand for office space is expected to be strong, with a 20 per cent increase in office-based jobs expected in Central London between 2011 and 2031. The London Office Policy Review expects demand to rise by 2.55 million sq ft during this period, providing a solid case for the market over the next two decades.

The next few years are forecast to see very limited new office completions across Central London. More activity and investment is expected, but it will take time to bring new schemes to market. Strong rental growth should encourage further development. There is likely to be a shortage of Grade A space over the next four years resulting in further rental price growth, as shown in Figure 13. Canary Wharf may benefit from the high availability of Grade A space. As the market recovers, it is forecast that there will be a greater degree of pricing differential between prime and secondary stock as the shortage of prime space becomes more acute.

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King Sturge, West End Offices Q2, August 2010

Savills, Central London Office Review and Outlook, August 2010

Glossary

Availability: space on offer in the market that is available to occupy within six months

Development pipeline: a development in which the main contract has been completed and work has started

Prime rent: the typical top rental price currently being offered in the market

Take up: the amount of transactions undertaken including offices let or sold, developments pre-let/sold

Vacancy rate: the percentage of all space that is unoccupied or not rented

GLAECONOMICS

Greater London Authority
City Hall
The Queen's Walk
London SE1 2AA

Tel: 020 7983 4922

Fax: 020 7983 4674

Minicom: 020 7983 4458

Email: glaeconomics@london.gov.uk

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