Market stalls due to COVID-19

Fall in flexible office leases

London remains an investment safe haven

Knight Frank

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THE LONDON OFFICE MARKET REPORT

Q1 2020

MARKET ROUNDUP

The vacancy rate across London is steady at 5.7%

◆

45% of all stock under construction is spoken for

◆

Demand is building on the sidelines as global investors take aim at alpha cities, such as London

The unthinkable

The first three months of 2020 were punctuated by book-end events, with the start of the quarter ushering in confidence and resilience in the occupational and investment markets, in the wake of the decisive General Election results in December 2019. The final two weeks of the quarter saw the unthinkable unfolding, with COVID-19 forcing a near seizure in all activity as social distancing and lock down rules became enforced.

With the market disrupted through March, quarter end figures were impacted, with 2.0m sq ft of leasing deals concluded during Q1, down on the long term average of 3.3m sq ft and also lower than the Q1 2019 figure of almost 3.0m sq ft. The ebb in activity is in part due to large HQ requirements completing at the end of last year, such as L'Oréal and Monzo, but more significantly, the impact on market sentiment as the COVID-19 story unfolded elsewhere in the world. The reduction in lease deals contributed to a 1% rise in availability to

2.0m
sq ft
OF LEASING DEALS CONCLUDED DURING Q1

13.2m sq ft, while the vacancy rate across London held steady at 5.7%.

Professional services, finance & banking and corporates (41%) together accounted for the lion's share of leasing activity, with flexible office providers notably less active in Q1. In total 178,000 sq ft was leased by flexible office providers, compared to 981,000 sq ft in Q3 2019. We explore the impact of the pandemic on the serviced office market in our COVID-19 Series: *London Flexible Office Market report*.

Life as we know it altered forever?

The COVID-19 pandemic also dampened requirements, which retreated by 4% to 9.2m sq ft during Q1 and early indications are showing ongoing declines into Q2. The falling level of requirements are in part linked to nervousness around committing to new space at a time when there is a very real threat of a prolonged period of economic contagion not just in the UK, but globally, as the virus continues to undermine global economic growth.

In addition, a structural shift in working patterns driven by a rapid entrenchment of remote working, means that companies will inevitably be reviewing their real estate not only from a cost perspective, but also from a future work pattern perspective, with the potential for a strategic change to more flexible working patterns and for a greater proportion of staff working from home more often. Indeed Deutsche Bank's April survey of City based workers showed that 57% intended to work from home between one and three days a week in the future. This was up from 39% in March.

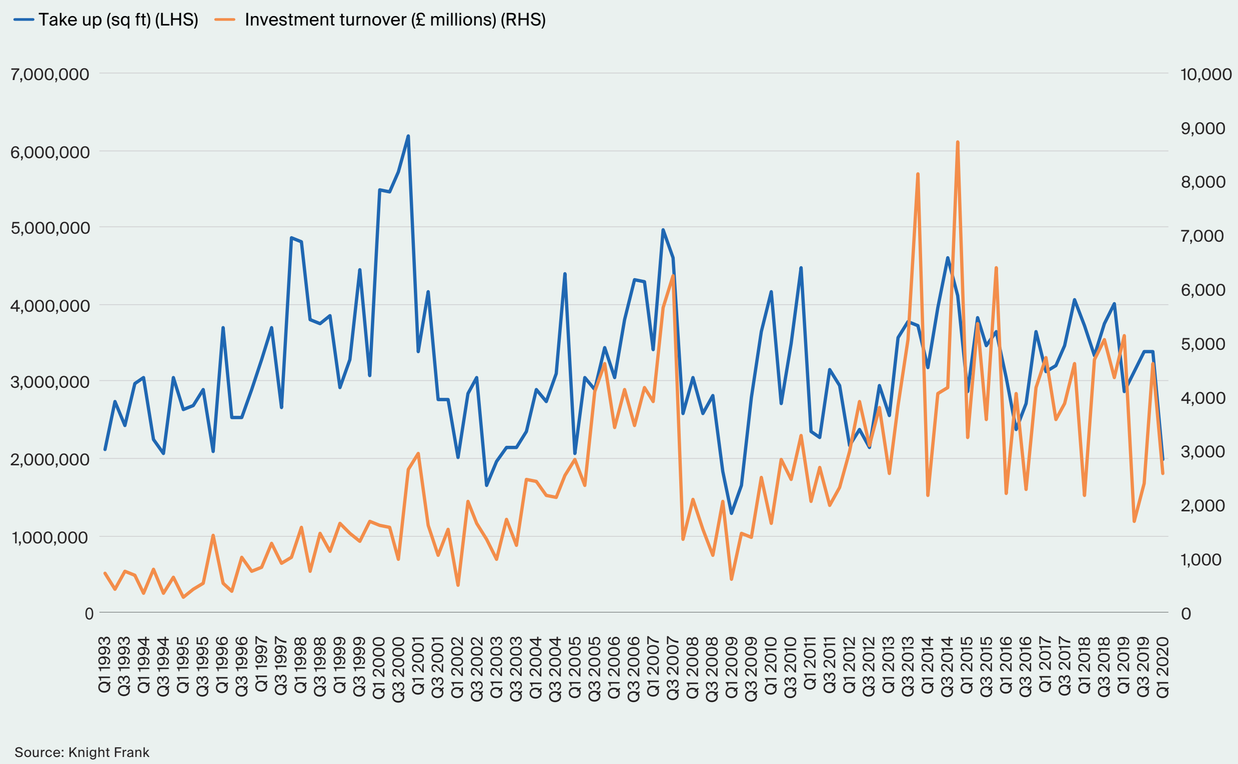
Even global tech giant, Facebook has announced plans to allow up to half its global workforce to work from home permanently, following in the footsteps of Twitter. It is too early to quantify the true impact of such a change on the supply-demand equation, but needless to say that we are likely in the midst of a structural change in occupier and more importantly, employee behaviour and expectations.

Stable rents

Nonetheless, before COVID-19 shocked the market, upward pressure on already record high rents was evident, with new benchmark leasing rates emerging in several instances for best in class, grade A office space. This was being driven by a chronic shortage of grade A space, with 45% of all stock under construction already spoken for. Any notion of pushing rents on however was curtailed by the COVID-19 crisis, with headline prime rents holding steady: £115 per sq ft in the West End; £72.50 per sq ft in the City and £52.50 in the Docklands.

A structural shift in working patterns driven by a rapid entrenchment of remote working, means that companies will inevitably be reviewing their real estate.

London office market performance



Source: Knight Frank

While on the face of it the impact on rents appears to have been minimal in Q1, we have seen early signs of a drift in lease incentives. We are closely monitoring supply and tenant release space, which could have a material impact on how the market behaves in the coming months.

Investment levels ease

Away from the leasing market, investment activity too has eased, with turnover reaching £2.6bn in Q1; down on the £4.6bn recorded in the final three months of 2019 and also below the long term average of £3.4bn.

It was always going to be a challenge to improve on the surge in activity experienced following the decisive results of the UK General Election at the end of 2019, but the COVID-19 pandemic clearly also pushed investors into a holding pattern.

Prior to the pandemic induced global crisis, one of the biggest challenges for investors seeking to secure London assets was the dearth of stock. To put this into context, our 2020 Global Capital Tracker showed £48.4bn waiting around the world to be deployed into London's office market; however in Q1 there was just £2.5bn available to purchase.

The COVID-19 crisis is yet to expose any distressed assets, although there have been a limited number of motivated sales.

The COVID-19 crisis is yet to expose any distressed assets, although there have been a limited number of motivated sales by those with exposure to more vulnerable sectors such as leisure, tourism, or commodities. For the most part, vendors are holding firm on pricing, however downward pressure is building and yields are likely to move out once more, albeit marginally.

London's safe haven status is a trump card

Positively for London, this continues to enhance the safe-haven status the city has enjoyed historically. That said, challenges around debt funding, enhanced scrutiny of occupier covenant strength and global travel restrictions which are hampering property inspections suggest activity is likely to remain suppressed for the time being.

Looking ahead, evidence suggests that demand is building on the sidelines as global investors take aim at alpha-cities, such as London, with a proven track record of delivering long-term returns and offering wealth preservation opportunities. Indeed our internal agent sentiment surveys, which we've been running since the w/c 16 March have shown a rise in international interest in London assets.

The dearth of stock is obviously a major hurdle, which may drive capital down other avenues, including, but not limited to: JV developments, sale and lease backs and indeed partial investment, or outright acquisitions of UK REITS, as was evidenced by the purchase of £50m worth of LandSec shares by Hong Kong billionaire, Thomas Lau, in late May, which amounted to a 1.25% stake.

LONDON OFFICE MARKET

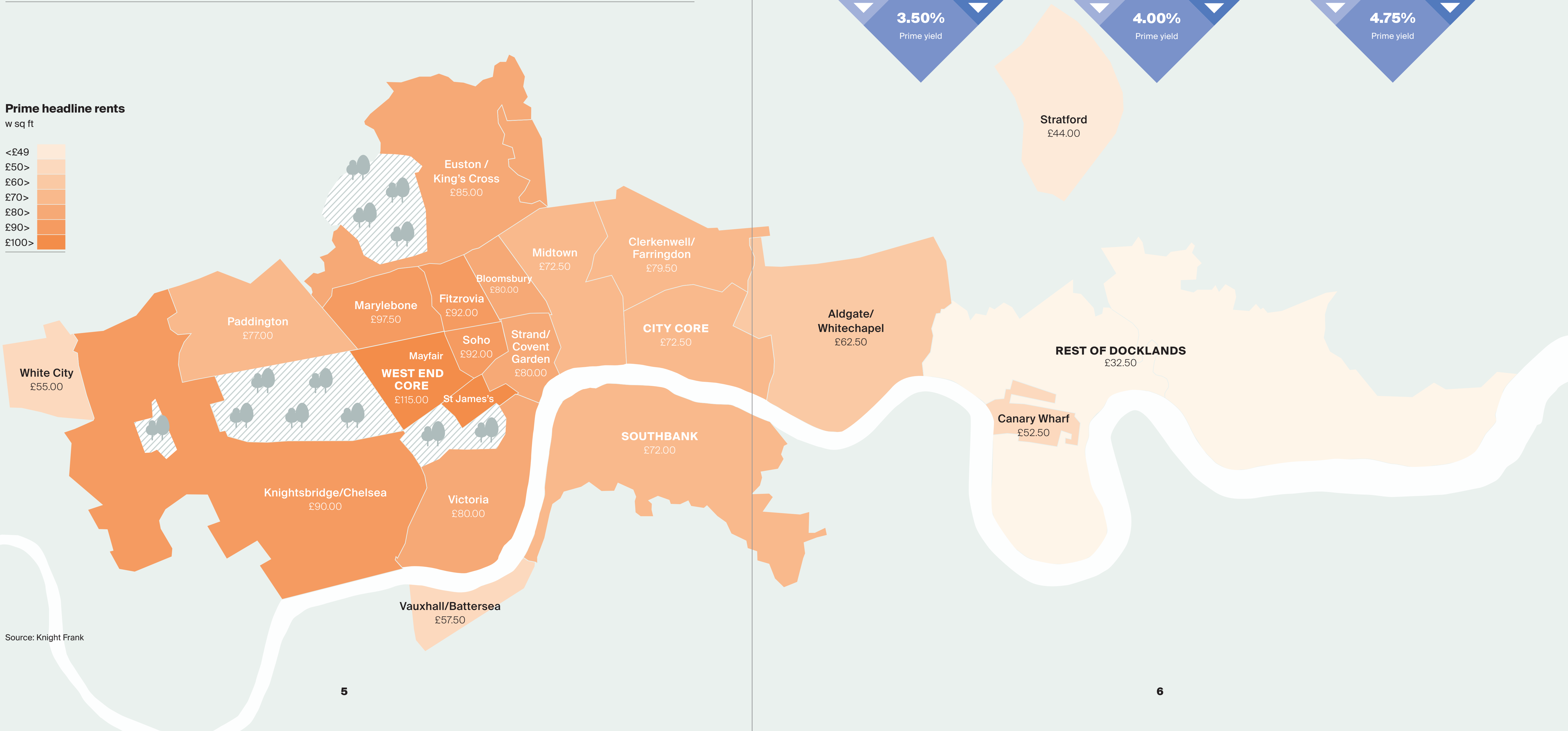
Performance dashboard Q1 2020

Key performance indicators

	▼ 2.0m TAKE-UP (SQ FT)	▲ 13.2m AVAILABILITY (SQ FT)	◀▶ 5.7% VACANCY RATE	▼ 11.3m UNDER CONSTRUCTION (SQ FT)
Change on				
Q4 2019	-41% ▼	1% ▲	0% ◀▶	-13% ▼
LTA	3.2 million sq ft	15.1 million sq ft	6.7%	9.2 million sq ft

Prime headline rents
w sq ft

<£49
£50>
£60>
£70>
£80>
£90>
£100>



Source: Knight Frank

THE LONDON OFFICE MARKET REPORT Q1 2020

WEST END CORE

◀▶ £115.00 per sq ft Prime headline rent
£1.08bn Investment turnover ▼
0.63m sq ft Take-up ▼
◀▶ 3.50% Prime yield

CITY CORE

◀▶ £72.50 per sq ft Prime headline rent
£1.48m Investment turnover ▼
1.28m sq ft Take-up ▼
◀▶ 4.00% Prime yield

DOCKLANDS

◀▶ £52.50 per sq ft Prime headline rent
£28m Investment turnover ▼
93,000 sq ft Take-up ▼
◀▶ 4.75% Prime yield

MARKETS IN REVIEW

THE CITY & SOUTHBANK

Arrows throughout the report show how values have increased, decreased or stayed the same since the last quarter unless specified

◀▶ £72.50	▼ 1.28 m	▲ 7.16 m	▼ £1.48 bn	◀▶ 4.00%
RENT (PER SQ FT)	TAKE-UP (SQ FT)	AVAILABILITY (SQ FT)	INVESTMENT TURNOVER	PRIME YIELD

Robust occupier activity

Mirroring the performance of all other key London markets in Q1 2020, leasing activity was significantly reduced. Take-up reached 1.28m sq ft in the City, which is 28% down on the long-term average. There were 88 deals during the first quarter, four of which were over 50,000 sq ft, compared to five in Q4 19.

The largest deal during the quarter was Linklaters LLP's acquisition at 20 Ropemaker Street, EC2, totalling 298,560 sq ft, which also makes it the largest deal during the quarter. The professional services sector accounted for the largest proportion (36%) of take-up during the quarter, followed by ITT (14%), and media (13%).

Active requirements still above average

Active demand reduced by 14% in the first quarter, to 4.44m sq ft. The decline is largely due to several requirements being withdrawn or placed on hold in response to the COVID-19 outbreak. Having said that, the level of active requirements for office space is still 5% ahead of the long-term average.

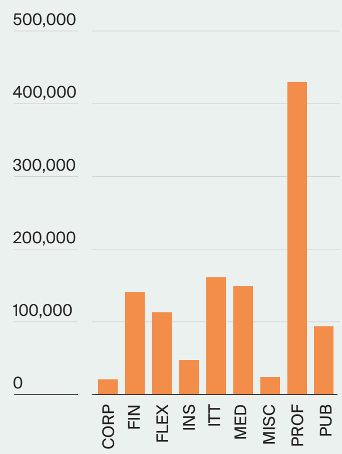
At the close of Q1, there were 16 businesses seeking over 100,000 sq ft in the City.

At the close of Q1, there were 16 businesses seeking over 100,000 sq ft in the City, however, there are just seven buildings available that can meet these requirements.

Supply remains tight

Availability now stands at 7.16m sq ft, which is up 11% on Q4 2019, although this level is still 15% below the long-term average.

City take-up by sector - Q1 2020
sq ft



Source: Knight Frank

This equates to a vacancy rate of 5.7% in the City market and 7.4% in the City Core, compared to a long-term average of 7.1% and 8.2% respectively.

And with 51% of the 4m sq ft of office space due to complete this year already spoken for, the number of options for businesses will be limited to just a little under 2m sq ft. This assumes all schemes originally due to complete this year are able to meet advertised schedules, which appears unlikely thanks to COVID-19 induced delays. If we were to assume all stock due this year were to complete on time and take-up of new and refurbished space held at long-term average levels, this would translate into just seven months of supply.

Investors retreat

Investment turnover reached £1.48bn in the first quarter, which although down by 52% on the previous quarter, is still up 29% year-on-year. The largest deal of the quarter was Union Investment's purchase of a 50% stake of Watermark Place, EC4 from joint venture partner Oxford Properties.

Overseas purchasers once again dominated, accounting for 95% of all deals by price, one of the highest market shares in recent quarters.

Domestic purchasers remained active in the smaller lot size range, accounting for 43% of all deals by number. The most dominant sources of capital during the quarter were German and North American funds, accounting for 38% and 18% respectively.

Availability was 9% down on last year at £3bn across 63 properties. Of this figure, £2.2bn was under offer at quarter end, leaving only £700m available to buy.

With the market essentially on hold for a prolonged period of time as the nation-wide lockdown took effect in the final weeks of Q1, investment turnover has dropped sharply, chiefly because the market has been effectively shut for an extended period, with deals being aborted and buyers seeking to renegotiate deals already in train.

MARKETS IN REVIEW

WEST END

£115.00	▼ 0.63 m	▼ 3.75 m	▼ £1.08 bn	3.50%
RENT (PER SQ FT)	TAKE-UP (SQ FT)	AVAILABILITY (SQ FT)	INVESTMENT TURNOVER	PRIME YIELD

Significant fall in transactions in Q1

The first quarter of the year witnessed a significant fall in transaction activity in the West End, with take-up totalling just 630,000 sq ft, half the level recorded in Q1 2019 and significantly below the long-term average of 1.2 m sq ft. There were 129 transactions during the quarter, with an average deal size of 4,587 sq ft. The largest deal during the quarter was Google's acquisition at Euston Tower, NW1 totalling circa. 115,000 sq ft. There were no further transactions over 50,000 sq ft.

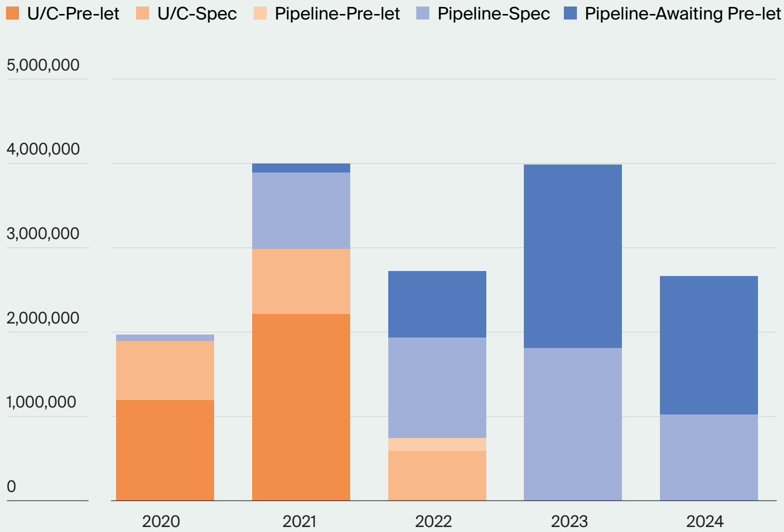
The majority of take-up comprised of second-hand stock, with just 30,000 sq ft of new and refurbished stock acquired during the quarter.

Vacancy declines as supply remains tight

Despite the dip in take-up levels, the vacancy rate fell to 4.4%, from 5% in Q4 2019, as the total amount of stock available fell by 14% to just under 3.8 million sq ft.

Overall, supply remains tight, with just a little more than 868,000 sq ft of space under development speculatively.

West End development pipeline
sq ft



Source: Knight Frank

ITT and finance dominate take-up

The ITT (21.4%) and finance (20%) sectors remained the most active in the quarter, with the total amount of space leased by each sector reaching 134,000 sq ft and 125,000 sq ft, respectively. There were a total of 129 lease transactions during Q1, with 91% being for space under 10,000 sq ft. The average deal size was 4,857 sq ft.

As at the close of Q1, there were active requirements totalling 2.2m sq ft, with nearly 72% of demand stemming from the finance, professional and corporate sectors. In total, there were 8 known requirements for space in excess of 50,000 sq ft exclusive to the West End, with only 7 buildings able to accommodate a space take of this size.

Overall, supply remains tight, with just a little more than 868,000 sq ft of space under development speculatively.

Investment activity recedes

As with other markets in London, investment turnover declined in the West End, falling by 26% to £1.08bn during Q1. The largest transaction in Q1 was Legal & General's purchase of Sanctuary Buildings, SW1 from Hana Financial Group.

Availability in the West End is 8% down on the previous quarter standing at £2.44bn. Of this figure, £590m was under offer, leaving £1.85bn available to purchase.

TAKE-UP TOTALLED JUST
630k
SQ FT

MARKETS IN REVIEW

DOCKLANDS & STRATFORD

£52.50	93,000	2.26 m	£30 m	4.75%
RENT (PER SQ FT)	TAKE-UP (SQ FT)	AVAILABILITY (SQ FT)	INVESTMENT TURNOVER	PRIME YIELD

Occupier activity steady

During the first quarter of 2020, take-up in the Docklands market reached 93,000 sq ft, down on the 243,000 sq ft recorded in the previous quarter. The two largest transactions during Q1 were in the rest of Docklands area, both at The Import Building in East India Dock, totalling 59,000 sq ft: Anglia Ruskin University took 33,000 sq ft, while the Global Banking School acquired 26,000 sq ft.

These two transactions amounted to almost 64% of total take up in the Docklands in Q1. In Canary Wharf there was only one transaction, totalling 11,000 sq ft. This was to CSC Administrative Services who acquired space at 5 Churchill Place.

Education sector dominates

The education sector was by far the most dominant sector in Q1, accounting for 81% of take-up, followed by the professional sector (12%). Over the last 12-months, however, the financial sector has leased the majority of stock, totalling 471,000 sq ft, which equates to 36% of all space let.

Active requirements remain strong

Looking at active requirements in this market, demand increased by 33% to 484,000 sq ft, pushing

requirements well above the long-term average. Furthermore, we are tracking a number of occupiers currently located in other submarkets across London who are actively considering the Docklands and Stratford market as part of their wider search.

Supply increases slightly

Supply increased by 2% quarter-on-quarter totalling 2.26 m sq ft at the end Q1. Supply of new and refurbished stock totalled 810,000 sq ft. There are just seven units across the entire Docklands and Stratford market that could provide an occupier with 100,000 sq ft or more. The largest of these include 1 Cabot Square, E14; 40 Bank Street, E14; and The Import Building, Republic, E14.

Looking at active requirements in this market, demand increased by 33% to 484,000 sq ft, pushing requirements well above the long-term average.

Pipeline

Looking at the development pipeline, there is currently 900,000 sq ft under construction in the Docklands and Stratford market; however, 16% has already secured a tenant. There is 552,000 sq ft due to complete in 2020, notwithstanding inevitable delays, across two buildings; 20 Water Street, Wood Wharf, E14 (211,000 sq ft) and Cargo, 25 North Colonnade, E14 (341,000 sq ft), both of which are fully available.

Investment

There was one investment transaction during the first quarter of 2020; Ensign House, E14, was purchased for £28.2 million, reflecting a capital value of £269 per sq ft.

Supply of investment stock is extremely limited with just one asset available in Canary Wharf, however this is currently under offer. In Stratford, there are two assets on the market, with a number of opportunities available at International Quarter London, E20.

THE EDUCATION SECTOR WAS BY FAR THE MOST DOMINANT SECTOR

81%

OF TAKE-UP

KEY STATISTICS

	Q3 19	Q4 19	Q1 20	% CHANGE 3 MONTHS	% CHANGE 12 MONTHS
TAKE-UP (SQ FT)					
West End	1.03 m	1.53 m	0.63 m	-59%	-50%
City	1.97 m	1.62 m	1.28 m	-21%	-9%
Docklands	0.38 m	0.24 m	0.09 m	-63%	-59%
Total London	3.38 m	3.38 m	2.00 m	-41%	-31%
AVAILABILITY (SQ FT)					
West End	4.59 m	4.35 m	3.75 m	-14%	-24%
City	6.14 m	6.43 m	7.16 m	11%	10%
Docklands	2.40 m	2.21 m	2.26 m	2%	-10%
Total London	13.13 m	12.99 m	13.17 m	1%	-6%
VACANCY RATE					
West End	5.3%	5.0%	4.4%	n/a	n/a
City	4.8%	5.2%	5.7%	n/a	n/a
Docklands	10.8%	10.9%	10.4%	n/a	n/a
Total London	5.6%	5.7%	5.7%	n/a	n/a
UNDER CONSTRUCTION (SQ FT)					
West End	5.65 m	5.60 m	4.89 m	-13%	-4%
City	5.99 m	6.15 m	5.50 m	-11%	-10%
Docklands	0.91 m	1.20 m	0.91 m	-24%	-53%
Total London	12.55 m	12.95 m	11.30 m	-13%	-14%
DEVELOPMENT COMPLETIONS (SQ FT)					
West End	0.02 m	0.06 m	0.08 m	33%	-60%
City	0.89 m	0.42 m	0.68 m	62%	-7%
Docklands	1.25 m	0 m	0.30 m	n/a	n/a
Total London	2.16 m	0.48 m	1.06 m	121%	14%
INVESTMENT TURNOVER					
West End	£0.62 bn	£1.46 bn	£1.08 bn	-26%	-61%
City	£1.77 bn	£3.07 bn	£1.48 bn	-52%	29%
Docklands	£0 bn	£0.11 bn	£0.03 bn	-75%	-98%
Total London	£2.39 bn	£4.64 bn	£2.59 bn	-44%	-50%
PRIME YIELDS					
West End	3.75%	3.75%	3.75%	n/a	n/a
City	4.50%	4.50%	4.25%	n/a	n/a
Docklands	–	4.75%	4.75%	n/a	n/a

Source: Knight Frank

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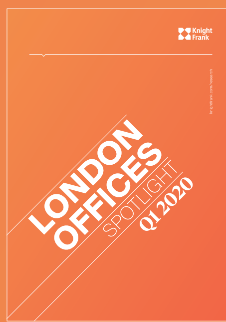
COVID-19 Series – London Serviced Office Market



London Offices Spotlight Q1 2020

The London Report 2020 – Highlights

General Note

This report has been prepared by Knight Frank Research, the research and consultancy division of Knight Frank. Knight Frank Research gratefully acknowledges the assistance given by the London office teams in the compilation and presentation of this material. Certain data sourced from LOD. All graph data sourced by Knight Frank.

Technical Note

The following criteria have been adopted in the preparation of this report.

i. All floorspace figures quoted in this report refer to sq ft net.

ii. Take-up figures refer to space let, pre-let, or acquired for occupation during the quarter.

iii. Availability refers to all space available for immediate occupation, plus space still under construction which will be completed within six months and which has not been let.

iv. Availability and take-up are classified into three grades:

New/refurbished: Space under construction which is due for completion within six months or space which is currently on the market and is either new or completely refurbished.

Second-hand A Grade: Previously occupied space with air-conditioning.

Second-hand B Grade: Previously occupied space without air-conditioning.

v. Demand figures quoted in this report refer to named requirements for over 10,000 sq ft.

vi. Under construction figures quoted in this report refer to developments of over 20,000 sq ft which are currently underway. They do not include properties undergoing demolition.

vii. Investment figures quoted in this report refer to accommodation where the majority of income/potential income is from office usage and comprises transactions of £1 m and above.

The data includes standing investments, site purchases and funding transactions.

viii. This report is produced to standard quarters.

Quarter 1: January 1 – March 31,
Quarter 2: April 1 – June 30,
Quarter 3: July 1 – September 30,
Quarter 4: October 1 – December 31

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