REAL ESTATE SECTOR RESEARCH

UK Office Real Estate Market View

Summary

The main segments of the Central London office market, including the City and West End, have experienced an improvement in leasing activity in recent months, as reflected by a relatively strong and sustained recovery in take-up. In particular, demand has been mostly concentrated in Grade A offices, which suggest increasing tenant preference for higher quality office spaces. At the same time, vacancy rates have risen owing to increased supply. As a result, rent performance has been moderate.

Looking ahead, we expect the strength of office leasing demand will largely be dependent on the evolving work-from-home dynamics. In the coming months, office demand should rise with more people in the UK returning to the workplace as companies progressively introduce hybrid working models. On the supply-side, stronger pre-let of future supply for the West End compared to the City may suggest a faster rate of absorption of new space added into the West End submarkets. Coupled with recovering demand from the technology and financial sectors, this may help to alleviate further upward pressure on vacancy rates and support a recovery in rents. Overall, we believe that the outlook for office rental growth has improved.

Latest performance indicators - July 2021

	Take-up	Supply	Vacancy	Rent (£ per sq ft)	
Segment	(sq ft)	(million sq ft)	(%)	Grade A	Grade B
City	362,563	12.56	9.1%	73.27	54.94
West End	276,007	8.06	7.0%	73.02	69.13

Source: Savills

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UK Office Real Estate Market Overview

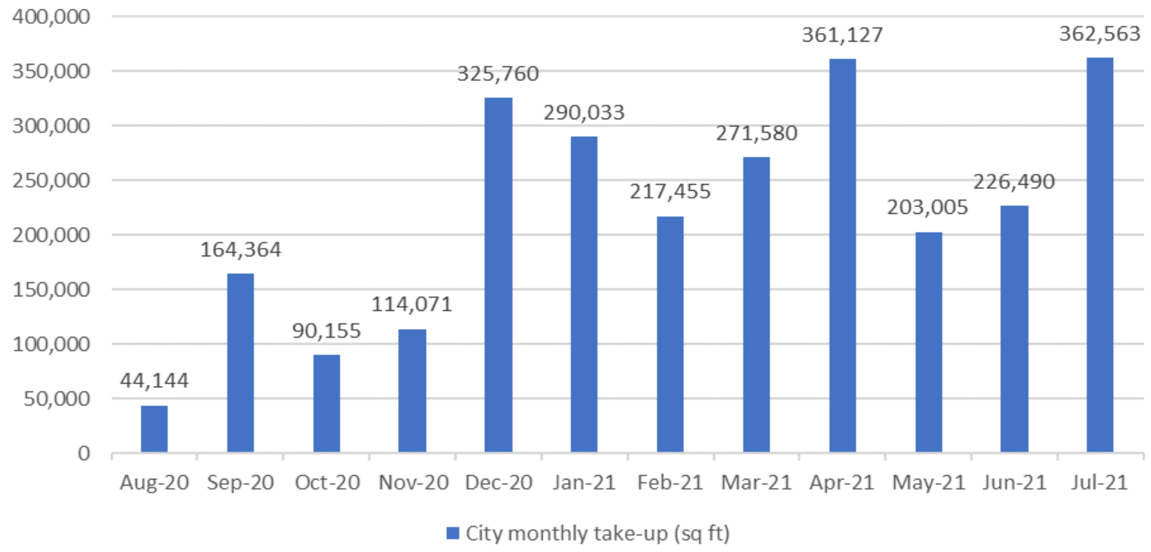
(I) Strong recovery in take-up

Central London – City [1]

During Q2 2021, the City saw an improvement in occupier sentiment. According to Jones Lang LaSalle (JLL), take-up moderated in the City submarkets in Q2 2021, with 646,000 square feet (sq ft) transacted during the period. This was 31% above the volume leased in Q2 2020, but down 16% from Q1 2021. Meanwhile, total office space under offer rose by 45% quarter-on-quarter (q-o-q) to reach 1.1 million at the end of June 2021. JLL highlighted that while this is below the 10-year quarter average of 1.4 million sq ft, it suggests that take-up should strengthen into 2H2021. Similarly, we note from Knight Frank that take-up rose in the City in Q2 2021, with a majority of leasing transactions in the City core [1] submarket.

More recent data by Savills showed that leasing activity in the City reached 362,563 sq ft in July 2021, a 60.1% m-o-m increase. This was the highest monthly reading since March 2020 and marked the third consecutive month of increase in take-up. Savills highlighted that the pickup in take-up reflects growing demand for space in the City. The data of monthly take-up for the City are summarised in **Exhibit 1**.

Exhibit 1: City monthly take-up



Source: Savills

The increase in take-up during the month brought year-to-date July 2021 (YTD July 21) take-up to 1.93m sq ft, down by 11% from the same period a year ago, and 43% below the long-term average take-up for this point in the year. In particular, we note from Savills that there continues to be a strong preference for Grade A space as 89% of YTD July 21 take-up has been of such quality. A similar trend was observed across the significant transactions in July 2021, with all leasing activity recorded for Grade A offices, as shown in **Exhibit 2** on the next page. Savills highlighted that sustained levels of strong occupier demand for new stock has resulted in pre-lets accounting for 30% of space that has been let so far in 2021.

[1]: Please refer to the Appendix section on page 14 for further details on the boundaries of the City and City core

Exhibit 2: Significant July transactions in the City

Address	Floor/s	Sq ft	Grade	Rent achieved	Tenant	Lessor
Warwick Court, 5 Paternoster Square, EC4	N/A	130,000	A	Confidential	T. Rowe Price	Mitsubishi
Two New Ludgate, 60 Ludgate Hill, EC4	7, 8, 9	59,620	A	£62.50	Mazars	Mizuho
TwentyTwo, 22 Bishsopgate, EC2	42	25,376	A	Confidential	Fidelis	Axa
60 Threadneedle Street, EC2	7	22,400	A	Confidential	Berenburg	Talbot
TwentyTwo, 22 Bishsopgate, EC2	11 part	12,467	A	£80.00	Development Bank of Korea	Axa

Source: Savills

In terms of sector, the Professional Services sector continued to dominate demand in July 2021 and accounted for 38% of total take-up during the period. Savills highlighted that this has been the running theme for the last 18 months and since March 2020. Another major contributor was the Insurance & Financial Services sector, which is the second largest contributor which accounted for 17% of total take-up since the pandemic began.

Central London – West End [2]

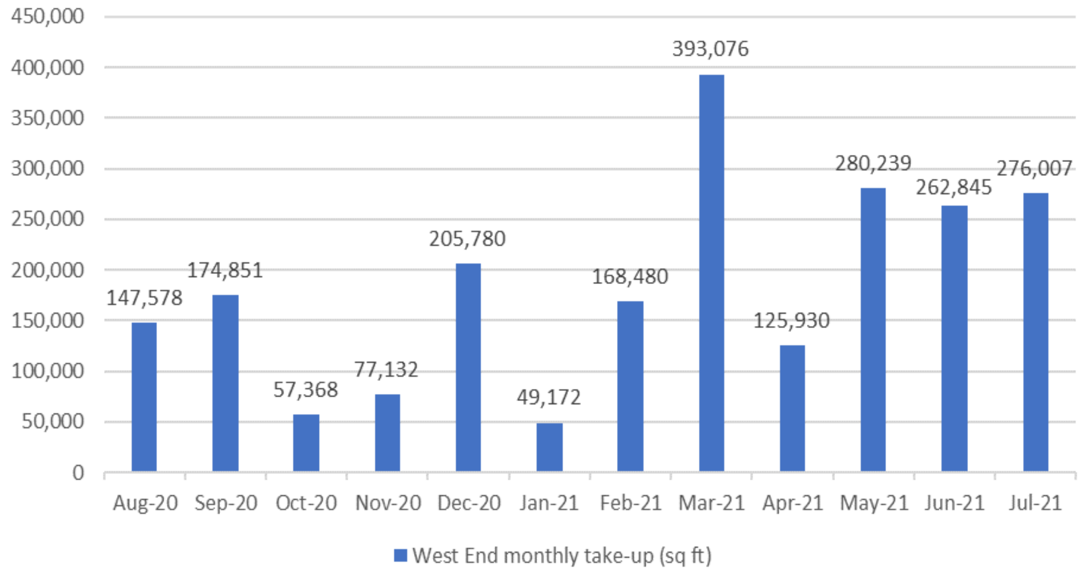
Similar to the City, leasing activity in the West End [2] rebounded strongly in Q2 2021. Take-up rose by 61% q-o-q to reach 793,000 sq ft during the period, according to JLL data. This was the highest quarterly take-up volume since Q2 2019. The Technology, Media and Telecommunications (TMT) sector acquired the most space and accounted for 42% of take-up in Q2 2021, while take-up in the Banking & Finance sector remained active and contributed 18%. Meanwhile, we also note from JLL that total space under offer almost doubled over Q2 2021 to reach 1.03 million sq ft at the end of June 2021. Under offer space was 43% ahead of the 10-year quarterly average of 721,000 sq ft. JLL highlighted that this suggests take-up will likely increase in 2H2021.

We note a similar trend based on Knight Frank data for Q2 2021. During the period, West End leasing activity recording a 39% q-o-q increase to 604,055 sq ft across 114 transactions. Leasing activity was concentrated in smaller office spaces, with 78 deals recorded for the 0 to 5,000 sq ft bracket and 25 deals recorded for the 5,000 to 10,000 sq ft bracket.

More recent data from Savills suggest a continued upward trend in leasing activity in the West End. In July 2021, take-up reached 276,007 sq ft, a 5.0% increase from 262,845 sq ft the previous month. This was the third highest monthly reading since the start of the pandemic, only falling behind March 2021 and May 2021. Savills highlighted that although month-on-month (m-o-m) take-up since the start of 2021 has not been consistent given the lockdown at the start of the year, on average leasing activity has risen by 56% per month from January. The data of monthly take-up for the West End are summarised in **Exhibit 3** on the next page.

[2]: Please refer to the Appendix section on page 14 for further details on the boundaries of the West End

Exhibit 3: West End monthly take-up



Source: Savills

The increase in July take-up brought YTD July 21 take-up in the West End to 1.55 million sq ft, 46% higher than the same period a year ago. Similar to the City sub-market, we note that the take-up of Grade A space in the West End made up a large proportion of total take-up in YTD July 21, at 89%. In comparison, the proportion was 57% during the corresponding period a year ago, which may suggest tenants' preference for higher quality office spaces in the West End. Most of the significant transactions in July 2021, as shown in **Exhibit 4**, were in respect to the leasing of Grade A offices.

Exhibit 4: Significant July transactions in the West End

Address	Floor/s	Sq ft	Grade	Rent achieved	Tenant	Lessor
136 George Street, W1	Entire	44,500	A	£81.25	Smart	Native Land
The Point, 37 North Wharf Road, W2	PtG,1	35,904	A	Confidential	Confidential	BT
6-8 Greencoat Place, SW1	Entire	32,400	B	£69.00	Fora	Derwent London
The Hudson, 350 Kennington Lane, SE11	LG-2	23,262	A	£52.50	University of Coventry	Aviva

Source: Savills

In terms of sector, the Tech & Media sector accounted for 18% of total space which was let in July 2021, which brought YTD July 21 take-up for the sector to 26% of overall take-up during the period. The other major sector was the Insurance & Financial sector, which also accounted for 26% of overall take-up during YTD July 21.

(II) Increased supply pushed up vacancy rates

Central London – City

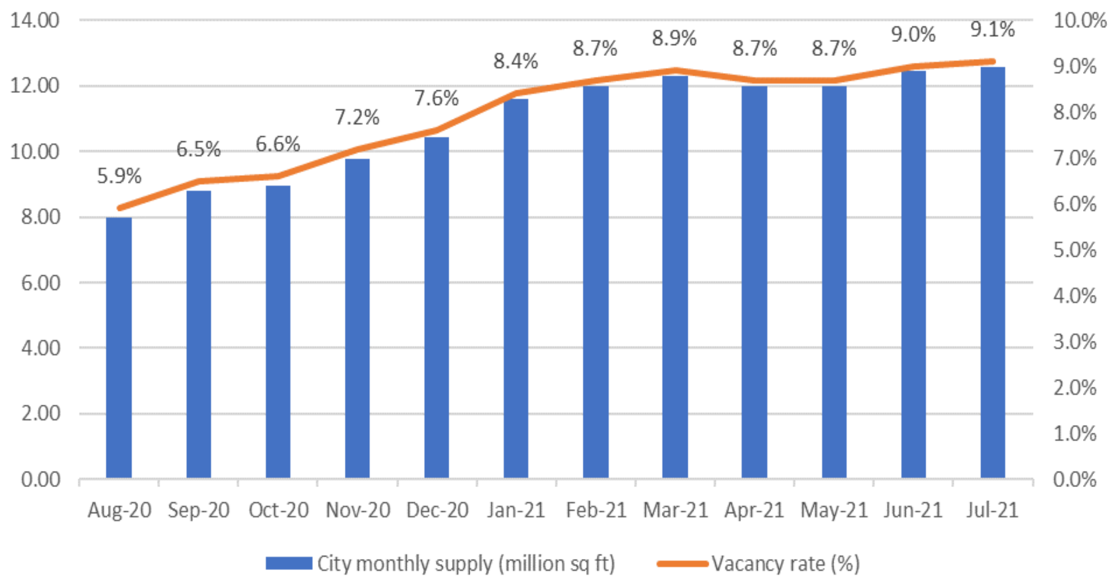
In Q2 2021, supply in the City continued to increase, reaching 9.9 million sq ft, and was at its highest level since Q4 2009, according to JLL. As a result, the overall vacancy rate rose and ended the quarter at 8.1%, compared to 7.3% at the ended of Q1 2021. We note similar developments from Knight Frank where increased availability had pushed up the vacancy rate during Q2 2021.

More recent data by Savills reflected a similar trend and showed that supply in the City sub-market rose slightly for the second consecutive month in July 2021. During the period, supply rose by 0.9% m-o-m to reach 12.57 million sq ft, corresponding to a vacancy rate of 9.1%. According to Savills, this is the highest vacancy level since 2009 and up 250 basis points on the long-term average of 6.6%.

At the end of July, 86% of supply was of Grade A standard, which is up on the five-year average. We note from Savills that the majority of supply (61%) was within the City core submarket, which recorded a higher vacancy rate of 11.6% compared with 6.8% in the City fringe.

The data of monthly supply and vacancy rate for the City are summarised in **Exhibit 5**.

Exhibit 5: City monthly supply and vacancy rate



Source: Savills

In terms of future supply, Savills data showed that the City has a development pipeline of 2.08 million sq ft in 2021, of which the bulk would come from refurbishments, as shown in **Exhibit 6**. Overall, 9% of the total pipeline in 2021 has been pre-let prior to completion. In total, over the period from 2021 to 2024, the City sub-market has a development pipeline of 14.36 million sq ft, of which 17% has been pre-let. Savills highlighted that with the continued demand for premium office space, it expects the pre-letting trend to continue with the 'flight to quality' trend showing no signs of subsiding.

Exhibit 6: City development pipeline

Sq ft	Refurb	Devs	Total	% Pre-let
2021	1,603,374	478,405	2,081,779	9%
2022	1,430,884	2,719,257	4,150,141	23%
2023	1,780,668	2,163,867	3,944,535	18%
2024	1,691,696	2,487,439	4,179,135	16%
Total	6,506,622	7,848,968	14,355,590	17%

Source: Savills

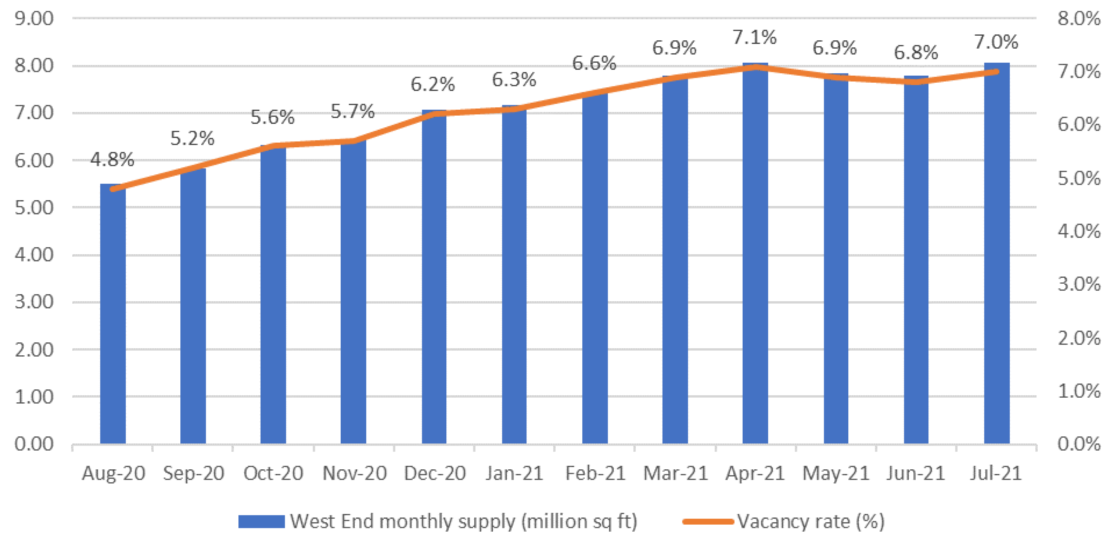
Central London – West End

In Q2 2021, reduced supply in the West End had alleviated the upward pressure on vacancy. Total supply across the West End submarkets declined over the quarter to reach 7.0 million sq ft, according to JLL. This followed 5 consecutive quarters of upward pressure. As a result, the overall vacancy rate fell to 7.3% as at the end of June 2021. However, this is still above the 10-year average of 4.1%.

Similarly, we note from Knight Frank that supply in West End reached 6.9 million sq ft in Q2 2021, down from 7.0 million sq ft recorded in Q1 2021. This comprised of 2.6 million sq ft of new & refurbished availability and 4.3 million sq ft of secondary space. The decrease in the levels of availability led to a fall in the West End vacancy rate to 7.8% in Q2 2021, down from 8.1% in the previous quarter.

However, more recent data from Savills showed that supply reached 8.06 million sq ft in July 2021, up by 3.6% m-o-m. The vacancy rate for the West End stood at 7.0% for July 2021. However, this is still above the long-term average of 4.5%. At the end of July, 60% of supply was of Grade A standard, relatively unchanged from 61% for the previous month. The data of monthly supply and vacancy rate for the West End are summarised in **Exhibit 7** on the next page.

Exhibit 7: West End monthly supply and vacancy rate



Source: Savills

In terms of development pipeline, the West End has a total of 12.65 million sq ft of new developments and extensive refurbishments scheduled to complete over the 2021-2024 period, of which 29% of these have been pre-let. This level of pre-let is much stronger compared to the 17% recorded for the City. Looking at specific years, we note strong pre-let for future supply in the West End of 64% and 34% for 2021 and 2022 respectively. This compares with 9% and 23% respectively for the City. The breakdown of development pipeline for the West End from 2021 to 2024 is summarised in **Exhibit 8**.

Exhibit 8: West End development pipeline

Sq ft	Refurb	Devs	Total	% Pre-let
2021	1,077,531	2,324,325	3,401,856	64%
2022	739,746	2,273,709	3,013,455	34%
2023	1,183,043	2,378,465	3,561,508	4%
2024	547,204	2,127,530	2,674,734	10%
Total	3,547,524	9,104,029	12,651,553	29%

Source: Savills

(III) Moderate rent performance

According to JLL, prime rents remained stable for the City and West End during Q2 2021. During the period, City prime rents remained unchanged at £70.00 per sq ft for the third consecutive quarter. Meanwhile, typical rent-free periods remained unchanged at 27 months, based on a 10-year lease term. For the West End, prime rents across all submarkets were unchanged in Q2 2021, with the core submarket recording at £115.00 per sq ft. Rent-free periods in the West End core [3] registered 24 months during the period. We also note from Knight Frank that rising levels of sentiment and low levels of availability for better quality space in the core markets led to rents being achieved which are above average levels of the market. At the end of Q2 2021, prime headline rents in the City of London were at £72.50 per sq ft with incentives at 27 months for a 10-year lease. Meanwhile, West End prime headline rents stood a £115.00 per sq ft and incentives were 24 months for a 10-year lease.

Meanwhile, latest data from Savills reflected a quarterly decline in average prime rents for both City and West End in Q2 2021. During the period, average prime rents in the City dropped by 6.4% q-o-q to £77.25, while that for the West End declined by 1.5% q-o-q to £116.75. A summary of prime rents for the City and West End during Q2 2021 is shown in **Exhibit 9**.

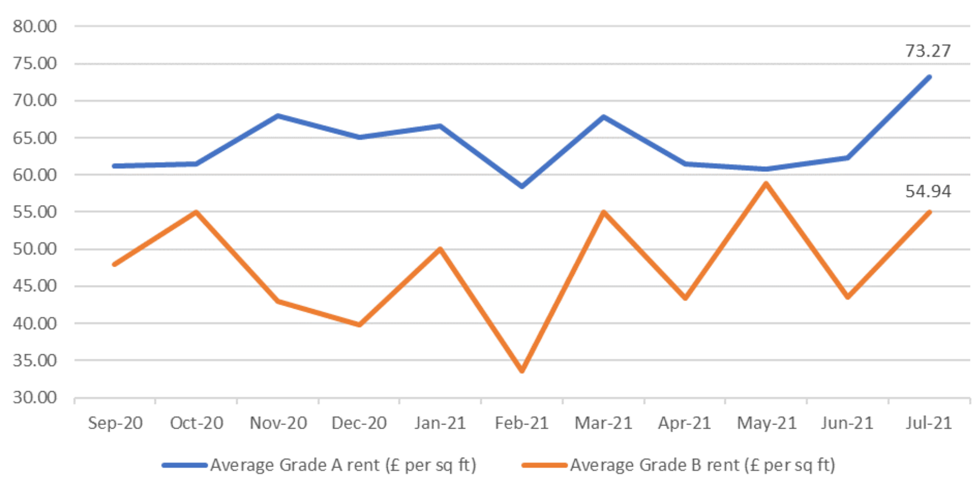
Exhibit 9: Q2 2021 prime rents for City and West End

	Prime rents (£ per sq ft) in Q2 2021	
Firm	City	West End
JLL	70.00	115.00
Knight Frank [(1)]	72.50	115.00
Savills	77.25	116.75

(1) Inclusive of South Bank
Source: respective real estate firms

More recent data from Savills suggest varying rent performance in the City and West End. In the City, average rents for both Grade A and Grade B offices recorded monthly growth of 17.6% and 26.3% respectively in July 2021 and registered at £73.27 per sq ft and £54.94 sq ft respectively, as shown in **Exhibit 10**.

Exhibit 10: City average rent for Grade A and Grade B offices

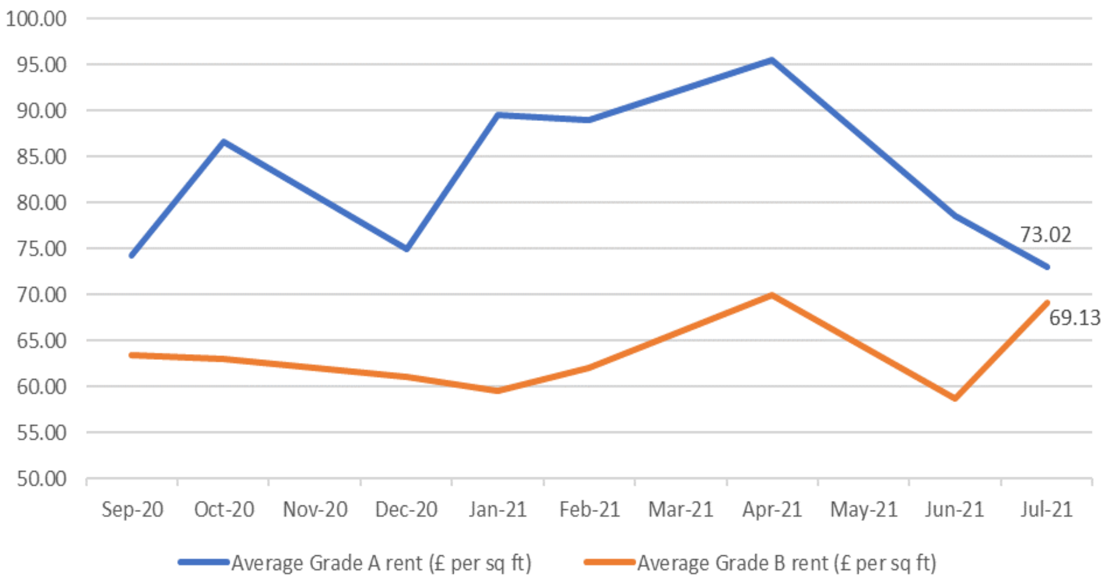


Source: Savills

[3]: Please refer to the Appendix section on page 14 for further details on the boundaries of the West End core

In the West End, average rents for Grade A offices declined by 7.0% m-o-m in July 2021 to £73.02 per sq ft, while Grade B office rents rose by 17.8% m-o-m to £69.13 per sq ft, as shown in **Exhibit 11**. Besides the opposite trend in Grade A rent performance for the two sub-markets, it is worth noting that growth in West End Grade B rents had lagged that of the City.

Exhibit 11: West End average rent for Grade A and Grade B offices



Several data points for specific months have been omitted due to unavailability of information
Source: Savills

(IV) Increased trend of hybrid work arrangements

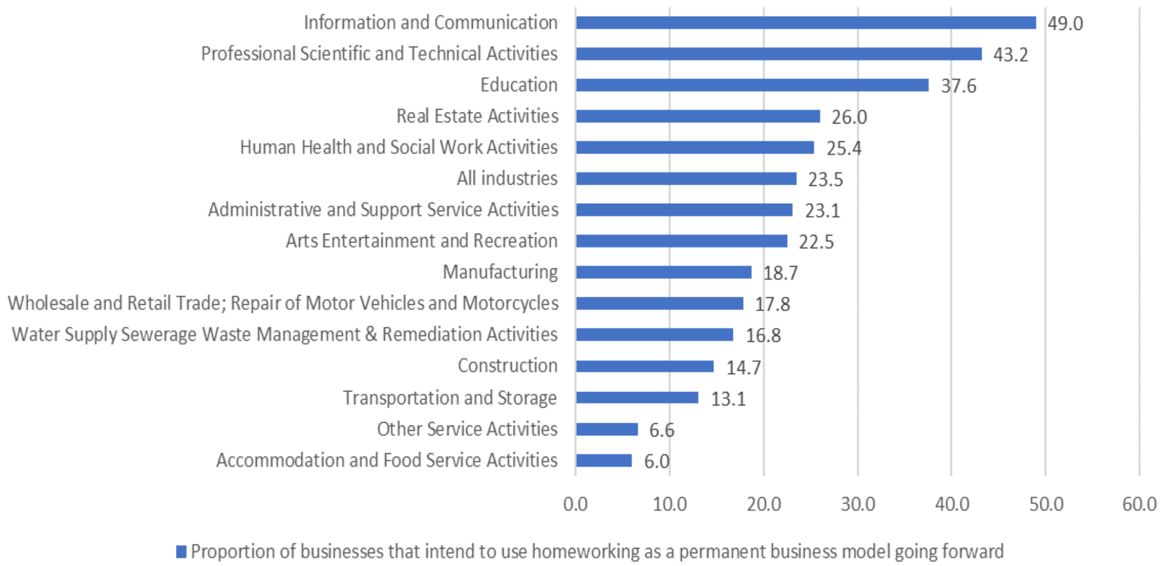
The Covid-19 pandemic has necessitated 'work from home' (WFH) as a default for a prolonged duration, and this may potentially induce a permanent structural shift in future work dynamics. In particular, there has been a rising trend of hybrid working in the UK.

Preference for hybrid working by businesses and individuals

According to the Office for National Statistics' (ONS) latest publication in June 2021 on business and individual attitudes towards the future of WFH, the proportion of working adults who did any work from home in 2020 increased to 37% on average from 27% in 2019, with workers living in London the most likely to WFH.

Importantly, we note that attitudes toward future remote working practices, as reflected in ONS' Business Insights & Conditions Survey (BICS) covering the period from 5 April to 2 May 2021, suggest the possibility of continued WFH in the long term. The BCIS results showed that 24% of businesses that had not permanently stopped trading intend to use increased WFH as a permanent business model going forward, as shown in **Exhibit 12**. In particular, businesses in the Information and Communication industry were most likely to intend to increase WFH in the future.

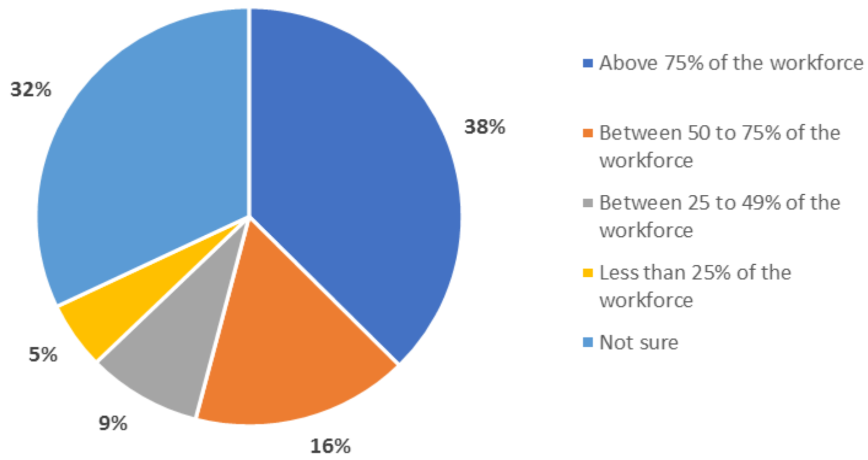
Exhibit 12: Proportion of businesses that intend to use WFH as a permanent business model going forward



Source: Office for National Statistics – Business Insights and Conditions Survey

The survey also highlighted that both businesses and individuals preferred a "hybrid" working approach (a mixture of both office and WFH) in the future. Of working adults currently WFH, 85% wanted to use a "hybrid" approach. Workers with higher incomes were more likely to expect a hybrid form of working, while those on lower incomes were more likely to expect to work exclusively from either their usual workplace or home. Meanwhile, nearly two-fifths (38%) of businesses expected 75% or more of their workforce to be at their normal place of work, as shown in **Exhibit 13** on the next page. Those that were uncertain of when they would return made up about one-third (32%) of the total sample.

Exhibit 13: Proportion of businesses that intend to use WFH as a permanent business model going forward



Source: Office for National Statistics – Business Insights and Conditions Survey

Increased adoption of hybrid work models by UK businesses

The need for flexible work arrangements amid virus-related restrictions has led to the increased adoption of hybrid work models in the UK. According to a recent report by the Financial Times (FT), many UK companies have created hybrid working models that are being rolled out in September 2021, with most wanting their staff in the office between 2 and 4 days a week. For instance, asset managers like Abrdn and Janus Henderson are adopting ‘blended working’, which would expect to see most staff returning to the office for around 2 days a week. Meanwhile, it was also reported that financial services companies such as Standard Chartered, BNP Paribas, Lloyds, Aviva, Santander and NatWest all expect staff numbers in the office to increase in the autumn as they roll out hybrid work plans.

The implementation of flexible working hours for workers has received government support. In August 2021, the UK government updated its guidance to recommend for a gradual return to the workplace. More recently, FT reported that workers in the UK will be granted the right to request for flexible work hours from their first day in a job, instead of after six months, under new proposals to be set out by the UK government.

Recent rising passenger commute suggests that more people in the UK are returning to the workplace. As reported by the International Railway Journal on August 27, latest data published by the Transport for London (TFL) showed that passenger numbers for London Underground’s (LU) network have recovered to 50% of pre-pandemic levels on weekdays, and 60% at weekends. On average, around 1.8 million passengers are travelling on the LU network every weekday. Weekend passenger growth has also been strong, reaching 58% and 62% of pre-pandemic levels on August 21 and August 22 respectively.

UK Office Real Estate Market Outlook

The main segments of the Central London office market, including the City and West End, have experienced an improvement in leasing activity in recent months, as reflected by a relatively strong and sustained recovery in take-up. In particular, demand has been mostly concentrated in Grade A offices, which suggest increasing tenant preference for higher quality office spaces. At the same time, vacancy rates have risen owing to increased supply. Overall, rent performance has been moderate thus far in 2021.

Looking ahead, the strength of office leasing demand will largely be dependent on the evolving WFH dynamics. As it stands, companies in the UK have started to implement hybrid work models to bring more staff back to the office, and recent rising passenger commute in London suggests that more people are returning to the workplace. In the coming months, we could expect a further rise in these numbers as more companies progressively introduce flexible work arrangements for their staff. These developments provide optimism over the possibility of a strong recovery in office leasing demand. Notably, with the continued demand for premium office space, the pre-letting trend is expected to continue with the ‘flight to quality’ trend showing no signs of subsiding. Sectors like Media & Technology, Professional Services and Insurance & Finance should remain as the main drivers of leasing demand.

On the supply-side, stronger pre-let of future supply for the West End compared to the City may suggest a faster rate of absorption of new space added into the West End submarkets. Coupled with recovering demand, this may help to alleviate any further upward pressure on vacancy rates and support a recovery in rents.

Overall, we note an improved outlook for office rental growth. Given the improvement in near-term economic growth prospects and occupier sentiment, Knight Frank revised upwards its forecasts of prime rental growth in the core Central London submarkets. Prime rents in the City core and West End core are expected to grow by an average of 3% and 2.8% respectively in 2021-2025.

Furthermore, we note improved guidance on the outlook of the London office market by UK property development & investment companies like British Land (BL), Derwent London (DL) and Land Securities Group (LSG). In its annual results presentation in May 2021, LSG reported strong rent collection for its office properties and highlighted the resilience of the London office market. LSG also highlighted its focus on achieving timely completion of its committed office developments. Similarly, DL highlighted in its recent interim results announcement in August 2021 that the London office market and its own portfolio have performed near the upper end of expectations. The company reported that it has seen higher rent collection with offices, which are now close to pre-Covid levels. Further, we note from BL’s latest operational update in July 2021 that the company sees good occupier interest for new and refurbished space for its Campuses (comprising office buildings), such as Broadgate in the City of London as well as Paddington Central and Regent Place in the West End, which it expects to be supportive of office rents and values moving through 2021.

However, the risk is that there are potential negative implications of a structural shift to hybrid working. While such arrangements may have short-term effectiveness in stimulating a gradual return of people to the workplace, long-term implementation of hybrid working could mean the downsizing of office workspaces as well as increased subletting for cost-savings.

Appendix

We note that the defined boundaries of the City and West End may differ across various real estate firms like CBRE, Knight Frank, JLL and Savills. Nevertheless, the City and West End generally comprise of certain areas as summarised in **Exhibit 14**.

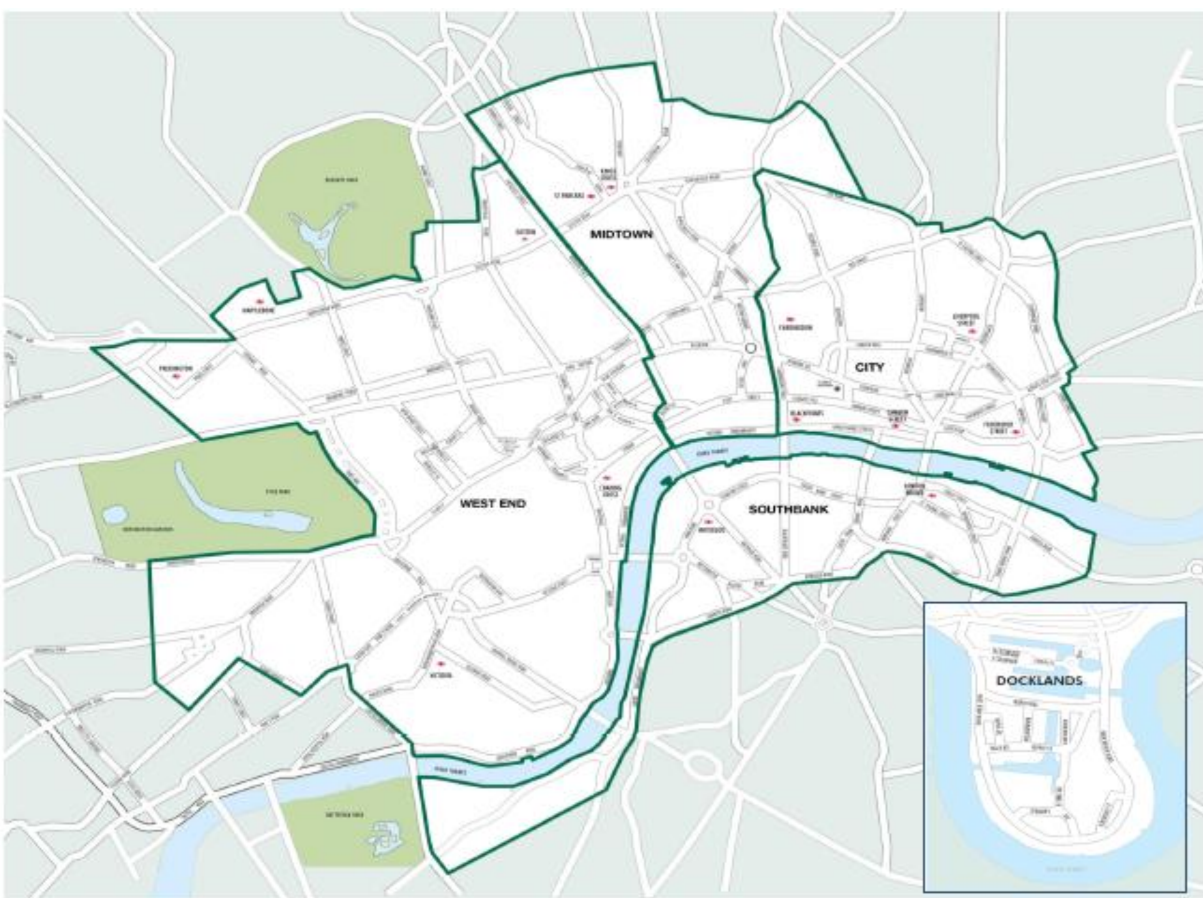
Exhibit 14: Areas generally covered by the City and the West End

Segment	Areas which are generally covered
City	Bishopsgate, City Road, Commercial St, Fenchurch St, Liverpool St, Old St
City core	Bishopsgate, Fenchurch St, Liverpool St
West End	Mayfair, Paddington, Victoria, Westminster
West End core	Mayfair

Source: CBRE, Knight Frank, Savills, FPA Financial

The map representation in **Exhibit 15** shows the demarcation of the various segments for the Central London office market.

Exhibit 15: Map representation of the Central London office market



Source: CBRE

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