LONDON

2017

COMMERCIAL EDGE

Carter Jonas

WELCOME TO OUR 2017 LONDON COMMERCIAL EDGE REPORT WHICH PROVIDES EVIDENCE-BASED ANALYSIS OF THE CITY'S COMMERCIAL PROPERTY MARKET FOR 2016 AND OUR FORECASTS FOR THE YEAR AHEAD. WITH THE APPROACHING UK-EU NEGOTIATIONS NOW AT THE FOREFRONT OF EVERYONE'S MINDS AND THERESA MAY CONFIRMING THAT THE UK WILL LEAVE THE SINGLE MARKET, THE DEBATE ABOUT HOW MUCH BREXIT WILL IMPACT ON LONDON HAS INTENSIFIED.

Many concerns relate to its possible impact on the City, particularly if the UK does leave the Single Market and loses its right to passport financial services into the EU. Many of the large investment banks have already started to make contingency plans, with some publicly stating that they may relocate thousands of jobs away from London.

Clearly, there is much to negotiate, with a deal possibly taking years to finalise. The short term will therefore see a degree of uncertainty, with some functions which require a bank to be domiciled in the EU or the Euro Area potentially being transferred to other countries.

However, our view is that London will remain a magnet for international finance for the foreseeable future. It is a pre-eminent global city and is unlikely to lose that status any time soon. We should remember that London is a great place for living, working, shopping, entertainment and education. It is one of the world's wealthiest, most transparent and accessible markets in terms of doing business - described by many as "the world's capital market".

Indeed, there are a whole host of reasons why Brexit will not be catastrophic for London. Firstly, the TMT (technology, media and telecommunications) sector has been the dominant driver of take-up in the last few years, unlike the financial services sector, which has helped to diversify the city's occupier base. **Figure 2** demonstrates the growth in professional, scientific and technical jobs in London as a percentage of the total over a twenty-year period.

Moreover, banks are unlikely to desert London *en masse*. There is a sizeable talent pool in the city along with a strong culture of banking and the international language of English, while many financial contracts are based around English law. London is a global financial centre, not merely a European one. EU-based banks such as Société Générale and BNP Paribas do not have significant London operations just because of passporting rights. It is also unlikely that rival cities such as Dublin, Paris and Frankfurt would be as attractive to banking professionals, nor would these cities be able to offer enough suitable office accommodation.

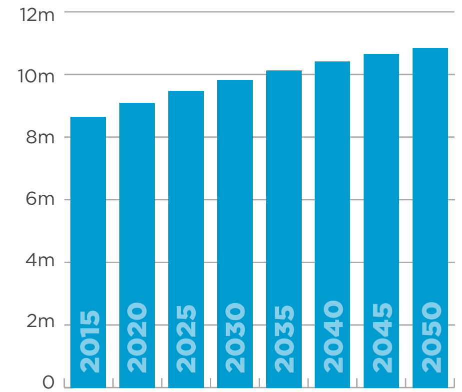
In addition, with the ongoing weak growth and instability in the EU and the Euro Area, banks are unlikely to transfer all their operations to the Continent. It is also worth remembering that the EU will not be the biggest growth market for financial services in the coming years – it will be Asia, Latin America and Africa. So, regardless of Brexit, London should remain a major global financial centre for many years to come.

London has a fantastic long-term growth story and is set to become a global mega-city in the next 15-20 years, with its population expected to increase from the current 8.7 million to just over 10 million by 2034 (as shown in **Figure 1**). That is an additional 1.3 million people - equivalent to the size of Birmingham.

Notwithstanding the short to medium term challenges that Brexit will bring, London needs to establish how it will accommodate this growth, notably in terms of housing and infrastructure provision. While there is no room for complacency, the city seems to be doing many of the right things. These include measures to reduce pollution, the creation of housing zones and opportunity areas with ambitious targets for new homes and jobs, plus significant investment in major infrastructure projects such as Crossrail 1 and 2 – all of which will help London maintain its status as a leading global city.

Figure 1 Population Forecasts for Greater London

Source: Greater London Authority



LONDON HAS A FANTASTIC LONG-TERM GROWTH STORY AND IS SET TO BECOME A GLOBAL MEGA-CITY

Figure 2 London Jobs % Breakdown by Sector, 1996 & 2015

Source: ONS

1996
2015

Primary and utilities
Real estate
Manufacturing
Other service activities
Arts, entertainment and recreation
Wholesale and motor trades
Public administration and defence, compulsory social security
Transportation and storage
Construction
Accommodation and food service activities
Financial and insurance activities
Education
Information and communication
Retail
Human health and social work activities
Administrative and support service activities
Professional, scientific and technical

0% 3% 6% 9% 12% 15%

OFFICES

Since the referendum in June 2016, the biggest impact on the central London office sector (West End, the City and Docklands) has been in the investment market, although in reality the market was already slowing before the vote. In 2015, central London offices recorded deals valued at just under £14 billion (source: Propertydata) – not the highest ever but nonetheless an excellent result. In contrast, 2016 saw a sharp fall to just over £10 billion.

A number of deals were derailed by the referendum result, although one positive trend to emerge in the aftermath of the vote was the continued interest from overseas investors, who accounted for 77% of transaction volumes in 2016. The largest deal of the year in the capital – and indeed the UK – was Canadian investor Brookfield's acquisition of the CityPoint building for £560 million. There were two other deals in London above £300 million, namely ENPAM's purchase of Principal Place for £382 million and China Life's acquisition of the Aldgate Tower for £346 million.

The more cautious sentiment has had a slightly negative impact on pricing. Prime office yields softened by 25 basis points, to end the year at 3.75% in the West End and 4.25% in the City. However, very low interest rates and the weakness of sterling – down by around 20% against the USD since the referendum – have helped to mitigate the impact on yields. Moreover, with 10-year gilts trading at around 1.3% as at mid-January, property yields still look good value against the risk-free rate.

So far, the impact on London's occupational market has not been as marked as in the investment market. In fact, the word "resilient" is frequently used to describe the current state of the market. However, leasing activity has fallen and take-up for 2016 as a whole is down by almost 25% on 2015. Midtown and the West End recorded the sharpest falls, with take-up down by 43% and 32% respectively. The year started well but activity declined sharply in Q2 and Q3, although Q4 saw a recovery as businesses adjusted to the referendum result.

To date, there has been limited impact on advertised rents, although landlords are beginning to be more flexible on discounts and rent free periods. Headline rents have edged down in the most expensive parts of the West End and the top rents in the City and Docklands are also expected to soften over the next year or so.

The highest rents in some locations - notably the West End - are simply too expensive, especially for medium sized and smaller occupiers. A weaker growth outlook is also a prospect on the back of Brexit uncertainty and some occupiers will inevitably delay decision-making. In addition, London is becoming more polycentric, helped by Crossrail and other new transport links. This means that the traditionally dominant locations such as the West End and the City are facing more competition from emerging locations such as Paddington, the South Bank, Battersea and King's Cross where occupancy costs are significantly lower.

Another major factor which will impact on the market in 2017 is the business rates revaluation, which is based on rents as at April 2015 and takes effect from April 2017. A large proportion of the market will experience significant above-inflation increases in business rates as a result of the changes. Inevitably, occupiers are seeking cost savings and questioning the need to retain all of their business functions in central London. Fringe locations, such as Hammersmith, the Docklands and Stratford, offer better value and more businesses are expected to move all or some of their operations to these areas over the course of the next 12-18 months.

With much debate about Brexit and the City, the fact that the growth of the TMT (technology, media and telecommunications) sector has outstripped that of financial services bodes well as it helps to insulate London from future shocks to the financial system. It is therefore reassuring to see the likes of Apple and Google committing to a sizeable presence in London for the longer term – two firms which obviously see beyond Brexit.

Figure 3

Central London Office Take-up

Source: EGi

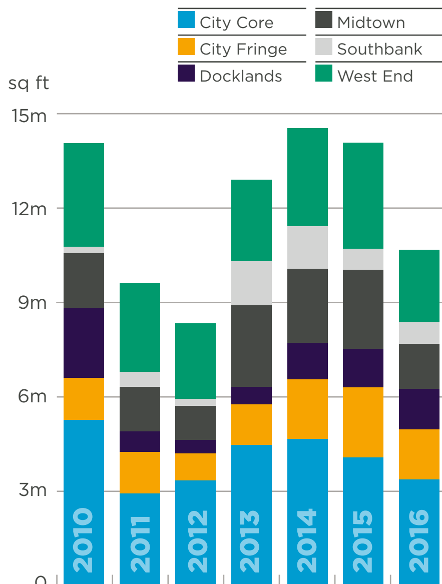
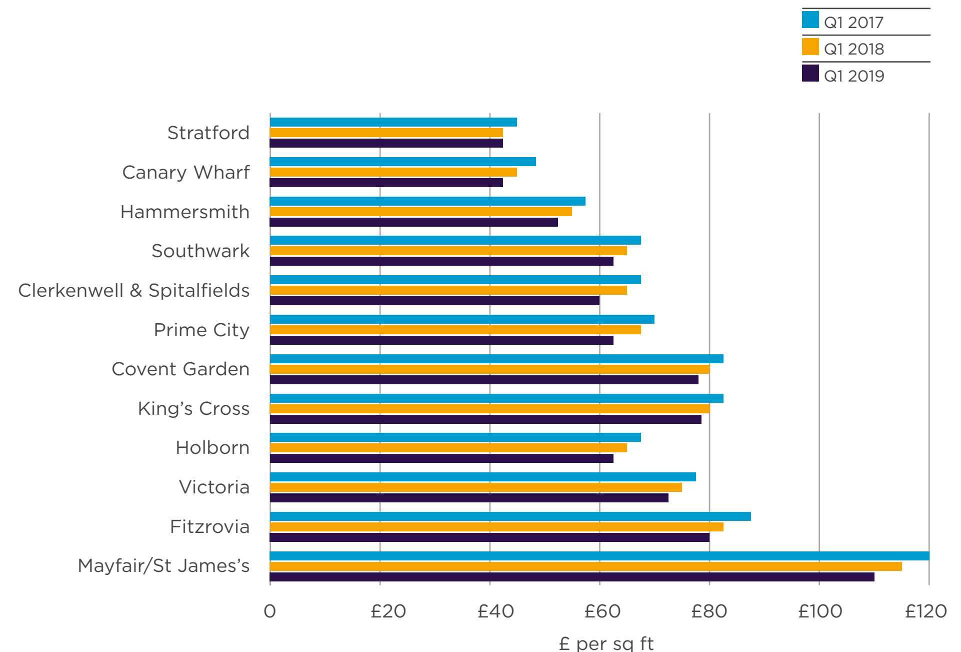


Figure 4

Typical Current and Forecast Office Rents for New and Refitted Grade A Space[1]

Source: Carter Jonas



RETAIL

London's retail sector has enjoyed a very long bull run following the 2008/9 recession, spurred on by the influx of international retailers and restaurant operators and the growth in tourist numbers. Indeed, 2016 saw Zone A (ZA) rents in the West End break through the £2,000 per sq ft barrier to end the year at ZA £2,200 per sq ft – a near doubling of rents over five years.

The main thoroughfares of Bond Street, Oxford Street and Regent Street have been attracting strong retailer interest and vacancy rates in these locations are close to zero. The Crown Estate continues to invest heavily in its assets, with the ongoing redevelopment of St James's, while the east side of Oxford Street has benefited from the development of the Crossrail station at Tottenham Court Road.

The whole of the West End will benefit from the arrival of Crossrail in 2018, with some forecasts suggesting that passenger numbers at some of the key stations may double in the coming years, bringing tens of millions of extra people into the area every year.

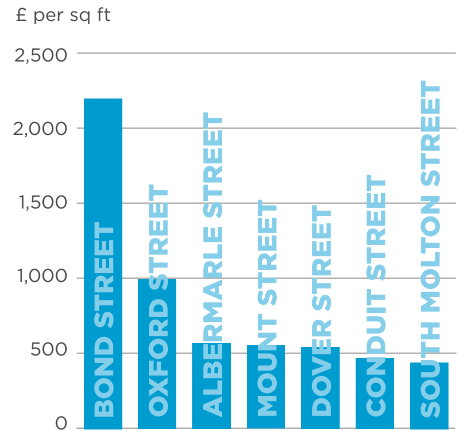
The lack of space on the main streets has led to overspill demand in the quieter side streets, notably in Mayfair where streets such as Albermarle Street and Dover Street have seen a sharp increase in demand from luxury retailers. This has led to a reinvigoration of these locations, higher footfall and very strong rental growth.

Other areas which did well in 2016 included the capital's large estates such as Covent Garden which continue to reap the rewards from a long-term, strategic approach to asset management, as well as emerging locations such as Battersea which are set to benefit from infrastructure improvements.

While 2017 is unlikely to see the same heady rates of rental growth recorded in 2016, this year should nonetheless bring significant activity in the London market, as the seemingly endless queue of incoming retailers chases a very limited supply of good quality space.

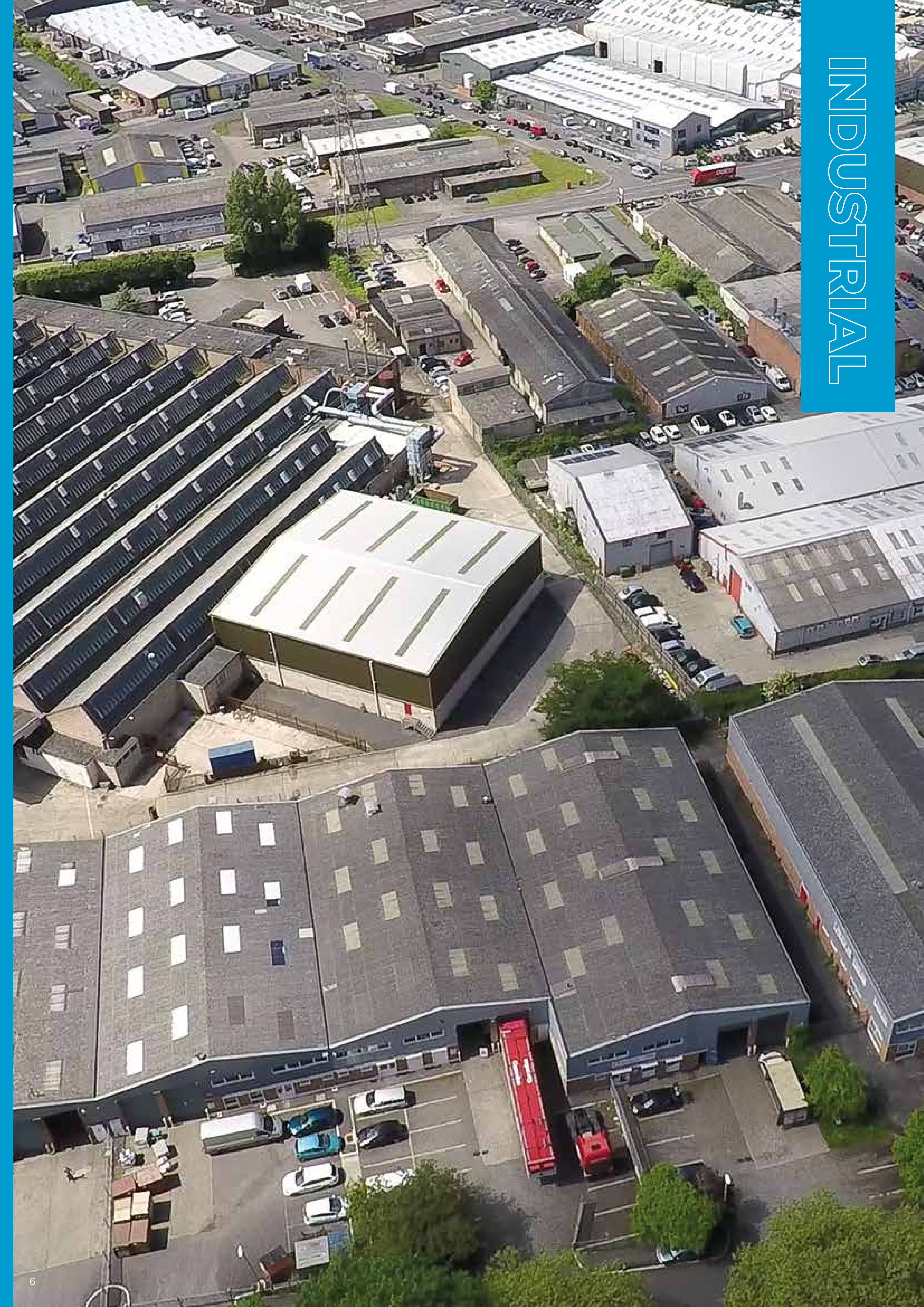
Figure 5 Retail Rents for Key London Streets (Zone A)

Source: Carter Jonas



THE WHOLE OF THE WEST END WILL BENEFIT FROM THE ARRIVAL OF CROSSRAIL IN 2018, WITH SOME FORECASTS SUGGESTING THAT PASSENGER NUMBERS AT SOME OF THE KEY STATIONS MAY DOUBLE IN THE COMING YEARS

[1] The graph illustrates typical forecast rents, excluding business rates, building service charges and all other outgoings, for new and refitted, prime located, Grade A office space, excluding rents for the upper floors of tower buildings.


INDUSTRIAL

In London and the South East, general sentiment in the industrial sector remains upbeat, despite a degree of uncertainty since last year's referendum result. The occupier market remains strong, with many users requiring additional modern and efficient accommodation, focused on more strategic locations in order to meet the evolving needs of retail and online demand. Indeed, Amazon signed one of the largest leasing deals of 2016, taking 2.2 million sq ft (multi-storey) at Roxhill's and Port of Tilbury's 70-acre London Distribution Park in Essex.

While retail remains the most active sector, there are other notable requirements from manufacturing firms. These have stemmed largely from the weak pound and demonstrate a reasonable recovery in this sector, at a time when the UK's relationship with Europe and the world is changing. Waste recycling meanwhile has seen increased demand for city fringe locations, fuelled by the construction industry.

In the energy sector, there are ongoing smaller infill requirements for battery storage facilities (STOR), aimed at reducing the volatility in electricity supply, while the self-storage operators also remain active on the back of growing consumer demand for such services. There are a number of large infrastructure projects in the pipeline including HS2 and the additional Heathrow runway, which may lead to CPO-driven displacement demand in the wider South East.

While development activity has increased, the availability of good quality space remains tight and rents have been on an upward trend. This has been exacerbated by the strength of the housing market and the conversion of brownfield sites to residential use, putting London's industrial rents under further pressure, with headline rents in parts of the capital now as high as £17.95 per sq ft.

However, despite the recent rental growth, rent-free periods are still prevalent in the market - albeit are tighter than a year ago at an average of three months for every five-year term guaranteed. With the exception of "design & build" units, lease terms remain flexible, with landlords still considering five-year terms.

The forthcoming changes to Energy Performance Certificates have had no significant impact as yet. However, as 2018 approaches and, together with the deferred rating revaluation coming in April 2017, the next two years could see higher costs for occupiers and landlords.

In the investment market, demand for good quality logistics stock has been robust and yields have remained stable, with yields on prime logistics assets ending the year at 4.25%. The largest transaction of 2016 in London and the South East was Capital Industrial's £79.5 million acquisition of the Heston & Airlinks Industrial Estate from Segro, reflecting a yield of 5.08%.

Looking forward, while the industrial market in London and the South East is unlikely to remain completely immune from Brexit uncertainty, it is better placed to withstand any potential slowdown than many other parts of the market. In addition, the growing structural change in the logistics sector could see more greenfield sites released near major transport links, particularly in the South East. While yields may soften marginally, occupier demand is generally outstripping supply, which is likely to lead to continued rental appreciation in selective locations.

Figure 6 Rental Values for Industrial Units in London & the South East[2]

Source: Carter Jonas

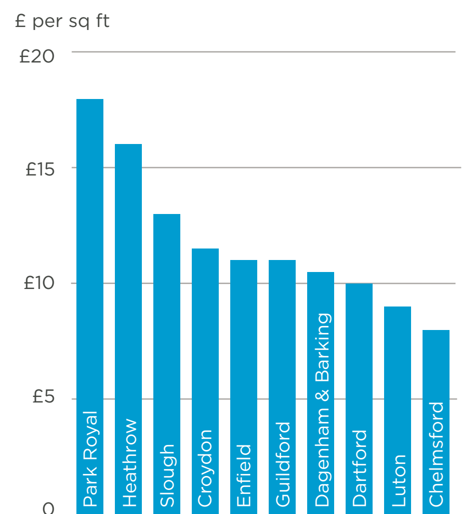
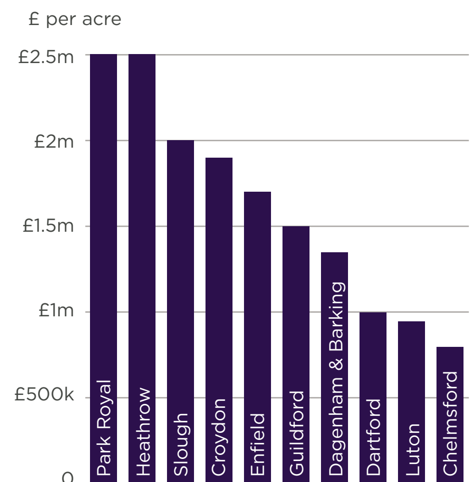


Figure 7 Land Values for Industrial Use in London & the South East[3]

Source: Carter Jonas



[2] Based on 10,000 (GIA) sq ft brand new unit in a prime location, with 45-50% site cover and 10% office content, and a lease term of 5-10 years.

[3] Based on land with an unrestricted B1(c), B2, & B8 planning consent with a 45-50% site cover and in a prime location. Also based on no abnormal cost for any environmental issues, site levelling or S106 (CIL) commitments etc.

OCCUPIER RELOCATION COSTS

2016 experienced a continuation of the trend among occupiers to relocate within central London and, increasingly, towards surrounding areas such as the Thames Valley, where lower rents and improving infrastructure make occupation increasingly attractive.

The key to a successful relocation is the development of a robust and comprehensive budget at the start of the process. This budget needs to incorporate not only fit out costs, but also suitable allowances for associated sundry items. Having reviewed the delivery outputs of occupiers across a range of sectors and locations over the past two years, Carter Jonas has identified the following trends and typical costs of relocation (**Figure 8**).

The key trends we have seen include:

- Relatively competitive fit out costs in Midtown locations due to their appeal to technology companies which prefer to work in an open plan and flexible space
- Higher expenditure and higher costs in West End areas, as the quality of fit out reflects more prestigious buildings, while smaller occupancies do not generate economies of scale
- Increasing expenditure in London's regional areas, as employers seek to create higher quality space than that found in central London which enables them to attract and retain staff
- Relatively stable fit out costs in the City, where most firms have occupied well-maintained buildings which require little supplementary work to services

THE KEY TO A SUCCESSFUL RELOCATION IS THE DEVELOPMENT OF A ROBUST AND COMPREHENSIVE BUDGET AT THE START OF THE PROCESS

Figure 8 Occupier Relocation Costs

	Low Specification	Medium Specification	High Specification
	• Minimal cellular offices • Limited feature decorative finishes • Minimal ceiling alterations • Simplistic amendments to mechanical and electrical services • Modest specification to finishes such as floor coverings and fabric selections	• Cellularised not exceeding 30% - standard specification glazed or solid partitioning • Feature ceilings to front of house only • Modified services to suit cellular layout • Higher grade/feature finishes to front of house • Some flexibility of data installation	• Highly cellularised and/or incorporating high grade acoustics • Supplementary services to improve base build provision • High joinery component to front of house • Feature finishes in key areas throughout • Flood wiring of data installation • Comprehensive audio visual/video conferencing systems
City / Midtown / West End	• Fit out = £52.00 • Furniture = £16.50 • Audio visual = £10.00 • Other = £7.00 • TOTAL = £85.50	• Fit out = £73.50 • Furniture = £19.00 • Audio visual = £11.50 • Other = £9.50 • TOTAL = £113.50	• Fit out = £92.50 • Furniture = £27.00 • Audio visual = £18.50 • Other = £11.50 • TOTAL = £149.50
Outer London	• Fit out = £30.00 • Furniture = £12.00 • Audio visual = £7.00 • Other = £5.00 • TOTAL = £54.00 Fee pack & contingency @ 15 - 25%	• Fit out = £61.00 • Furniture = £18.50 • Audio visual = £12.00 • Other = £8.00 • TOTAL = £99.50 Fee pack & contingency @ 15 - 25%	• Fit out = £85.00 • Furniture = £20.50 • Audio visual = £15.00 • Other = £12.00 • TOTAL = £132.50 Fee pack & contingency @ 15 - 25%

Source: Carter Jonas
Note: figures in the above table are on a £ per sq ft basis.

DILAPIDATIONS

Terminal dilapidation claims are damages sought by landlords against tenants for not complying with their repair, redecoration and reinstatement obligations in the lease.

The frequency of dilapidation claims within the commercial property market has increased due to diminishing lease terms and a prevalence of break clauses being exercised by tenants.

The RICS published findings for average settlement figures in 2010 based on a dataset of projects between 2007 and 2009. The RICS survey revealed average settlement figures of £9.54 per sq ft for offices and £7.27 per sq ft for industrial.

Carter Jonas has undertaken a comparative study of projects between 2015 and 2016, which showed an average of £10.61 per sq ft for offices and £6.65 per sq ft for industrial. Our analysis is derived from in-house data across our office network including Bath, Cambridge, Leeds, Oxford and London.

Our findings show that office settlements have increased by approximately 11% between the two studies, lagging behind the 15.6% inflation of the Tender Price Index during this period, as identified by BCIS.

In contrast, industrial settlement figures have experienced a decrease of 8.53% over the same period. We believe this can be attributed to the increase of protective measures such as Schedules of Condition engrossed to leases, which mitigate any future claims by limiting a tenant's liabilities.

PLANNING & DEVELOPMENT

As pressures on London's housing and infrastructure become increasingly acute, the phrase "getting a quart into a pint pot" often springs to mind. London's growth is expected to continue apace, so London needs to plan how it will meet its estimated needs for one million new homes without undermining its status as a World City. Is it now time to challenge the way we live, work and play?

In certain circumstances and to meet specific needs, reduced space standards might be adopted. For example, the developer Pocket Living has been successful with well-designed, high quality one-bedroom apartments of 418 sq ft, which is below the Greater London Authority's (GLA) space standard of 550 sq ft. While the question of "how small is too small?" is an obvious one, it is clear that such innovation helps meet the needs of one specific group and is also highly efficient.

As London sees an ever increasing number of tall buildings over 20 storeys, this approach to higher density living provides another option. With an annual target of 50,000 new homes, some change to London's skyline is inevitable, although the question remains as to how high we are willing to build. Typically, these schemes are also expensive to build and deliver lower levels of affordable housing, so this solution does not meet the need for more affordable homes.

A further option is whether a review of the greenbelt (and possibly Metropolitan Open Land) is needed to see whether more lower density housing can be accommodated and, in particular, whether more affordable housing can be delivered.

More shared space between different uses could also be part of the answer, with schools potentially sharing buildings with offices, leisure or health centres, for example. Arguably, provided a building is safe, high quality and managed properly, the size and use of space should not matter too much.

While many businesses have adopted flexible working practices, parts of London's transport network continue to see overcrowding on a regular basis. Should more be done to alleviate the pressure points by promoting a more flexible working day, extended trading hours for shops and a genuinely 24-hour tube service - changing the way we live.

In summary, accommodating London's future growth will not be easy and will require strong leadership to increase supply and change demand. We consider that this has to be led by the GLA as it is the only body which can drive the agenda on issues such as space standards, density and flexible working, as well as promote a sensible debate surrounding the greenbelt.

FORECASTS

London's long-term future is bright, with its population forecast to reach 10 million within the next 20 years, equivalent to adding a city of similar size to Birmingham. The key challenge for London will be how to accommodate this growth and strong leadership will be required to manage the debate around how this is achieved.

Infrastructure developments such as Crossrail will boost accessibility into and around the capital, potentially bringing millions of extra people into central London every year. New infrastructure will also facilitate the emergence of new retail and office locations such as Battersea and King's Cross.

In the short term, however, uncertainty relating to Brexit may affect demand, particularly from financial services firms, which is expected to impact mainly on City offices. In addition, with prime office rents in some parts of central London considered to be 'expensive' even before the referendum, the highest rents in the West End and the City are expected to edge down to more sustainable levels in 2017.

The new Business Rates revaluation, which comes into effect in April 2017, will lead to increased costs for many occupiers in locations which have experienced strong rental growth since the last revaluation in 2010. Fringe locations such as Hammersmith, the Docklands and Stratford, where occupancy costs are lower, are expected to see growing interest.

The industrial sector appears to be best placed to withstand a potential economic slowdown and should outperform the other commercial sectors in 2017. Occupier demand remains strong for limited space across London and the South East, while development opportunities may arise as more greenfield sites are released near major transport links.

Retail meanwhile is expected to continue to benefit from buoyant retailer demand, with numerous international operators still seeking to gain a presence in the capital. However, the pace of rental growth is expected to slow. The weaker pound has led to higher inflation and import costs for retailers, although this will also boost tourist numbers in the capital.

36 OFFICES ACROSS THE COUNTRY, INCLUDING 12 IN CENTRAL LONDON

Bangor
Basingstoke
Bath
Birmingham
Boroughbridge
Bury St Edmunds
Cambridge South
Cambridge North
Cambridge Central
Edinburgh
Harrogate
Kendal

Leeds
Marlborough
Newbury
Newbury - Sutton Griffin
Northampton
Oxford
Peterborough
Shrewsbury
Suffolk
Wells
Winchester
York

National HQ One Chapel Place
Barnes
Barnes Village
Fulham Bishops Park
Fulham Parsons Green
Holland Park & Notting Hill

Hyde Park & Bayswater
Knightsbridge & Chelsea
Marylebone & Regent's Park
Mayfair & St James's
Wandsworth
Waterloo

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