RESEARCH

THE LONDON OFFICE MARKET

Q3 2020

A GUIDE TO RENTS, RENT FREE PERIODS & MARKET TRENDS

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Carter Jonas

"Rising vacancy, declining rents and longer rent free period incentives will become the hallmarks of the London office market over the coming months."

During the summer there has been a plethora of emerging trends in the London office market that have evolved in the wake of the COVID-19 pandemic.

As leasing activity picks up, following the lifting of lockdown restrictions, further trends will begin to emerge and the extent to which rents and rent free periods are adjusting to a more challenging business climate will become apparent. This report, prepared by the Carter Jonas Research and Tenant Representation Teams, provides a summary of how events in the London office market are likely to unfold over the coming months to assist those tenants with upcoming lease expiries, rent reviews and break options in developing their post lockdown accommodation strategies.

Salaries typically represent the highest operating cost of most businesses, closely followed by real estate costs. Headcount reduction in some business sectors is therefore likely to follow the ending of the furlough scheme, in tandem with an increase in the volume of surplus tenant controlled office space being brought to the market.

Contrast with market conditions prior to the pandemic when many London businesses were investing for growth but were facing challenges in attracting the brightest and the best to their workforce. Real estate was, rightly, widely seen as an important factor in developing an effective employee recruitment and retention strategy.

Much of the pre-pandemic demand for London office accommodation was focussed on the new space market as businesses sought to trade up into better quality premises with the objective of using their work environment as a recruitment tool.

While real estate will no doubt continue to be an important factor in attracting and retaining a productive and profitable workforce, businesses will be looking at ways to reduce operating costs in order to maintain profitability in a challenging economic environment, where new opportunities for revenue growth will be scarcer.

Rising office vacancy, weak demand, declining rents and an expansion of rent free periods are therefore likely to be the hallmarks of the London office market for the foreseeable future. These factors do, of course, present opportunities for tenants that are facing a lease expiry or break option - by offering more choice and falling real estate costs. Not since the 2008 / 09 global financial crisis has there been such a good time for tenants to take advantage of weak market conditions to secure competitive financial and tenant-friendly lease terms.

"NOT SINCE THE 2008 / 09 GLOBAL FINANCIAL CRISIS HAS THERE BEEN SUCH A GOOD TIME FOR TENANTS TO TAKE ADVANTAGE OF WEAK MARKET CONDITIONS TO SECURE COMPETITIVE FINANCIAL AND TENANT-FRIENDLY LEASE TERMS."

Michael Pain
Head of Tenant
Representation Team
07715 001013
michael.pain@carterjonas.co.uk

SUMMARY OF KEY TRENDS

For the remainder of 2020, and much of 2021, the following trends are likely to become widely established in the London office market:

Advertised Rents

- a decline in advertised rents for both new and second-hand space reflecting rising vacancy and weak demand

Rent Discounts

- an increase in the discounts that can be negotiated on advertised rents as competition for fewer footloose tenants intensifies

Rent Free Periods

- a continued widening in rent free period incentives

Lease Length

- a move to shorter leases and the inclusion of more regular tenant only break options, as demand for greater lease flexibility increases

The bargaining position of tenants

- a shift in favour of tenants in the bargaining position in lease negotiations

Downsizing

- an increase in the number of businesses downsizing their real estate footprint to minimise exposure to real estate costs, and also reflecting reduced headcount

Office Vacancy

- an increase in the availability of second-hand, tenant-controlled, sub-let space as occupiers downsize and offload surplus accommodation
- an increase in new Grade A space vacancy as developments that were started during the 2018 / 19 construction cycle reach completion
- the emergence of the availability of new, previously unoccupied, surplus, Grade A space being offered by tenants that, prior to the COVID-19 pandemic, entered in to pre-letting agreements on buildings that were under construction

Office Relocation Activity

- a decrease in the number of tenants proceeding with their plans to invest in an office relocation, reflecting the uncertain business climate and the need to preserve working capital

Serviced Offices

- a short term uptick in demand for serviced and co-working space from those tenants with imminent lease expires and break options seeking to downsize and requiring 'stop-gap accommodation' until the business climate becomes more certain

"GIVEN THAT ONE OF THE KEY INGREDIENTS OF OFFICE DEMAND IS JOB CREATION, IT IS VERY LIKELY THAT DEMAND FOR OFFICE SPACE WILL REMAIN WEAK UNTIL UK AND WORLD ECONOMIC GROWTH IS RESTORED TO THEIR TREND LEVELS, AND SERVICE SECTOR EMPLOYMENT GROWTH RESUMES - SCENARIOS THAT MAY TAKE AT LEAST 12 – 18 MONTHS TO MANIFEST THEMSELVES."

Supply

During the summer there has been an increase in second hand office vacancy – a trend that is likely to gather pace over the coming months as a consequence of:

- downsizing – as some occupiers reduce headcount and offload surplus office space to reduce their operating costs in the wake of lower revenues
- business failures – requiring landlords to take back non-income producing space for re-letting

Vacancy levels are also set to increase in the new space office market as developments that were started during the 2018 / 19 construction cycle reach completion. However, the exposure of some developers to non-income producing floor space will, in some cases, be lower than anticipated, reflecting the fact that a significant number had entered in to pre-letting agreements with tenants early on in the construction programme, before the outbreak of the COVID-19 pandemic.

However, this raises the possibility of those tenants that committed to leasing large tracts of floor space on pre-let agreements now offering some of that space to the market on sub-leases, following a reassessment of their floor space needs in the wake of COVID-19. Landlords of new developments that have been part pre-let could therefore find themselves competing for a dwindling number of footloose occupiers with the very tenants that they had earlier pre-let space to.

The City of London, in particular, is vulnerable to a significant increase in office vacancy given that it is the sub-market with the biggest stock of office buildings and represents the largest of all the key London business districts.

Demand

Office vacancy in both the new and second hand markets in most size ranges, in many parts of London, is therefore set to rise during 2020 and 2021. However, given the increasing importance of employers providing a work environment that underpins the wellbeing of the workforce, it is probable that demand trends over the coming months will become focussed more on new space and accommodation that has been refitted with new building services, including air conditioning and passenger lift systems, rather than on lower grade second hand space, providing that it is competitively priced.

Demand for office space across London, and across virtually all business sectors, has weakened significantly since the first quarter of the year as a direct consequence of the economic slowdown precipitated by the COVID-19 pandemic.

The decline in demand for office space is being driven by two key factors:

- economic uncertainty – a significant number of those businesses that were considering a move prior to the outbreak of the COVID-19 pandemic have chosen to put their relocation plans on hold and are taking a 'wait and see' approach before committing to a large capital investment programme that an office relocation represents. The trend towards tenants taking short term lease extensions on their existing space to 'tread water' is likely to increase over the coming months, reflecting the uncertain business climate and the risks associated with a potential second wave of the COVID-19 virus.
- the adoption of new operating practices – lockdown measures have forced many businesses to re-evaluate the way that they operate - with a much greater bias, now, towards working from home, and shift working – to comply with social distancing requirements. Some of those businesses that were thinking of moving to larger premises are now questioning the need for more floor space and are, instead, favouring the option of staying put, enabling working capital to be re-allocated for new business generation initiatives to boost revenues.

"TRENDS IN SUPPLY AND DEMAND WILL, FOR THE REMAINDER OF 2020 AND MUCH OF 2021, CONSPIRE TO DEPRESS RENTS AND FOSTER LONGER RENT FREE PERIODS."

The ongoing 'Brexit' trade negotiations with the European Union add another layer of uncertainty in an already challenging business environment which is likely to further depress demand for London office space.

Given that one of the key ingredients of office demand is job creation, it is very likely that demand for office space will remain weak until UK and world economic growth is restored to their trend levels, and service sector employment growth resumes - scenarios that may take at least 12 – 18 months to manifest themselves.

THE LONDON OFFICE MARKET – TYPICAL LANDLORD'S ADVERTISED RENTS Q3 2020

(SPACE OVER 5,000 SQ FT)

£ per sq ft per annum *UF= Upper Floors*

Location	Grade A		Grade B
	New/Refitted	Refurbished	Refurbished
City			
Prime - Bank, Leadenhall Street	£62.50 - £75.00 (UF = £77.50 - £92.50)	£50.00 - £65.00 (UF = £67.50 - £85.00)	£40.00 - £49.50
Secondary - Blackfriars, Aldgate	£57.50 - £68.50 (UF = £70.00 - £85.00)	£45.00 - £57.50 (UF = £65.00 - £77.50)	£38.00 - £45.00
City Fringe			
North - Shoreditch, Clerkenwell	£65.00 - £75.00 (UF = £75.00 - £90.00)	£55.00 - £65.00	£38.00 - £55.00
North West - Farringdon, Smithfield	£70.00 - £85.00 (UF = £87.50 - £92.50)	£57.00- £68.50	£40.00 - £56.00
East - Spitalfields	£60.00 - £75.00	£48.00 - £60.00	£37.50 - £46.50
East - Aldgate East, Wapping	£50.00 - £59.50 (UF = £60.00 - £69.50)	£38.00 - £48.50	£34.00 - £37.00
South Bank			
Waterloo, Southwark, London Bridge	£67.50 - £75.00 (UF= £76.50 - £92.50)	£52.00 - £66.50 (UF = £67.50 - £75.00)	£39.50 - £52.50
Battersea, Nine Elms, Vauxhall	£55.00 - £67.50	£45.00 - £53.50	£37.50 - £43.00
East London			
Docklands Prime – Canary Wharf & Wood Wharf	£50.00 - £57.50 (UF = £58.50 - £62.50)	£32.50 - £42.50 (UF = £45.00 - £50.00)	£27.50 - £35.00
Docklands Secondary - Crossharbour	£32.50 - £39.50	£27.50 - £32.50	£22.50 - £27.50
Stratford	£45.00 - £49.50	£35.00 - £45.00	£22.50 - £29.50
West End			
Central - Mayfair, St James's (Prime)	£110.00 - £125.00 (UF= £130.00 - £140.00)	£85.00 - £105.00	£65.00 - £77.50
Central - Mayfair, St James's (Secondary)	£87.50 - £100.00	£72.50 - £88.50	£62.50 - £72.50
North - Euston	£65.00 - £78.50	£55.00 - £65.00	£42.50 - £52.50
North East - Fitzrovia	£78.00 - £90.00	£63.00 - £78.50	£48.00 - £62.50
North West - Marylebone	£78.00 - £92.50 (UF = £95.00 - £110.00)	£65.00 - £78.50	£50.00 - £62.50
South - Victoria, Westminster, Haymarket	£72.50 - £85.00 (UF = £87.50 - £92.50)	£57.50 - £72.50	£45.00 - £55.00
South West - Knightsbridge	£82.50 - £95.00	£72.50 - £80.00	£60.00 - £70.00
East - Soho, Regent Street, Leicester Square	£82.50 - £97.50 (UF = £95.00 - £110.00)	£67.50 - £82.00	£50.00 - £66.00
West - Paddington	£70.00 - £78.50 (UF = £82.50 - £90.00)	£55.00 - £66.50	£42.50 - £52.50
Midtown			
North - King's Cross	£72.50 - £87.50	£60.00 - £72.50	£47.50 - £57.50
South - Covent Garden	£70.00 - £82.50 (UF = £83.50 - £88.50)	£55.00 - £69.50	£47.50 - £55.00
East - Holborn	£62.50 - £70.00 (UF = £72.50 - £80.00)	£52.00 - £62.50	£40.00 - £50.00
West - Bloomsbury	£75.00 - £90.00	£60.00 - £72.50	£45.00 - £55.00
South West London			
Chelsea	£75.00 - £87.50	£62.50 - £72.50	£47.50 - £60.00
West London			
Kensington	£55.00 - £65.00	£45.00 - £53.50	£32.50 - £45.00
Hammersmith	£52.00 - £59.50	£40.00 - £50.00 (UF = £55.00 - £57.50)	£35.00 - £42.50
White City	£45.00 - £55.00	£40.00 - £45.00	£32.50 - £40.00
Chiswick	£47.50 - £55.00	£37.50 - £46.00	£32.50 - £37.50
Ealing	£40.00 - £50.00	£36.50 - £42.50	£30.00 - £36.50

Source: Carter Jonas Research

GRADES OF OFFICE ACCOMMODATION

For marketing purposes office accommodation is generally categorised into Grades which are defined as follows:

Grade A

Space fitted with air conditioning & passenger lift facilities & fully accessible raised floors for data / telecoms cable management

Grade B

Accommodation that typically incorporates under floor or perimeter trunking for data / telecoms cable management, rather than raised floors, and / or air cooling facilities, instead of an air conditioning system that dehumidifies & draws fresh air in to the building

Refitted space

Accommodation where the entire building, including the common parts, has been refitted and is "as new", incorporating new building services, including lighting, air conditioning and passenger lift facilities

Refurbished space

Premises where the existing building services have been overhauled, rather than replaced with new

Advertised Rents

The underlying investment value of commercial properties is much more sensitive to headline rents than the levels of incentives offered by landlords, such as rent free periods. As a consequence, there has, since the outbreak of the COVID-19 pandemic in March, been little discernible change in the levels of advertised rents for both new and refurbished office space that is being offered directly by landlords on new leases.

Future Movements In Advertised Rents

Over the next few quarters is its very likely that reductions in landlord's advertised rents will become widespread as competition intensifies between landlords with vacant new and refurbished space and tenants that are offering new, surplus, pre-let Grade A space and second-hand, lower cost, ready fitted out 'plug in and go' accommodation on flexible sub-leases.

Landlords with vacant space and tenants with surplus space will therefore be competing against each other in a market characterised by rising vacancy and weak demand.

To compete effectively, the landlords of new space, that will typically not be ready fitted out, will need to either reduce their advertised rents and offer longer rent free periods and / or fit the space out for the incoming tenant – and bear some of that fit out cost.

Over the next 6 – 12 months it is very probable that there will be a decline in advertised rents of between 10 – 15% for both new and refurbished office space as competition to attract tenants from a significantly diminished demand pool increases.

Rent Discounts

Despite the fact that there has been little movement in advertised rents for new and refurbished space that is being offered by landlords since the beginning of Q2 2020, there is growing evidence demonstrating that the discounts being offered on advertised rents in lease negotiations are increasing.

During Q1 2020, discounts on advertised rents were typically 1.5 – 3.5%. However, discounts of between 5 and 10% are becoming increasingly common. This trend is likely to continue for the foreseeable future.

Rent Free Periods

In a trend that mirrors that witnessed during the 2008 / 09 global financial crisis, rent free periods have widened significantly since March this year, reflecting the fact that landlords are now having to compete quite aggressively with each other, and with tenants with surplus ready fitted space, to secure lettings from a considerably smaller pool of footloose tenants.

The tables below illustrate the movement in rent free periods over the last two quarters:

Typical Rent Free Periods – City, West End, Midtown & South Bank

	Q1 2020	Q3 2020
5 year lease	9 – 12 months	12 – 16 months
10 year lease	20 – 24 months	25 – 28 months

Typical Rent Free Periods – Docklands

	Q1 2020	Q3 2020
5 year lease	12 – 14 months	14 – 17 months
10 year lease	24 – 27 months	26 – 30 months

The rent free periods associated with the Docklands office market reflect the wider disparity between supply and demand compared with the other London office sub-markets.

Depending upon how long a particular property has been on the market, and how indebted the landlord might be to its financiers, it is quite probable that longer rent free periods than those set out above could be negotiated on some buildings.

The trend towards longer rent free periods is likely to continue for the foreseeable future as office vacancy rises against a backdrop of weak demand.

"OVER THE NEXT 6 – 12 MONTHS IT IS VERY PROBABLE THAT THERE WILL BE A DECLINE IN ADVERTISED RENTS OF BETWEEN 10 – 15%"

Lease Length

Weak demand and rising vacancy is conferring a stronger bargaining position in lease negotiations on those tenants that have an imminent break option or lease expiry.

It is becoming easier for occupiers to secure shorter tenancies with more frequent tenant-only break options – to provide greater flexibility – and a hedge against the economic uncertainties associated with a possible resurgence in the spread of the COVID-19 virus.

Working From Home – The Practical Issues

Although activity in the London office market has been muted since the introduction of the Government's lockdown measures, several of the larger international law firms, that were the key drivers of demand for office space in the 60,000 sq ft plus market segment during the first quarter of this year, are reportedly continuing their property searches. The recent letting of c 150,000 sq ft at 280 Bishopsgate, EC2, to global law firm Baker McKenzie, which employs over 1,000 staff in London, is one such example.

This trend should come as little surprise for several reasons:

- like many knowledge based businesses, a law firm's operating model is arguably less suited to staff working from home for prolonged periods if junior and middle ranking staff are to be trained effectively, and gain sufficient experience, to drive the business forward
- the home environment for those with young children is less likely to be conducive for the quiet contemplation required to draft and analyse complex legal documents
- data security – the retention and protection of sensitive client hard copy and digital data is best achieved by keeping it within the security of the office, rather than transporting it and using it in the home environment

Workplace Design - 'Repurposing' The Office

The issues referred to above are common to many service sector businesses and it is for these reasons that the COVID-19 pandemic is unlikely to consign the concept of working in an office to the annals of history. Rather than dispensing with the need for office space, employers are 'repurposing' the way in which they are using their premises.

The use of office space as a 'hub', in tandem with an advanced desk booking system, is an operating model that is becoming popular – enabling employees the option of meeting up with colleagues while being reassured that their employer is controlling office headcount to comply with social distancing in the workplace.

The reconfiguration of existing accommodation, to render it more suited to teams that will be attending the office to participate in collaborative projects, is another emerging trend, in parallel with adopting new operating practices that are more biased towards home working and shift working.

In a recent survey of service sector businesses carried out by Carter Jonas, the majority of those canvassed explained that they have every intention of retaining an operating model predicated on working from office premises, emphasising the importance of having:

- a focal point for the business
- a place to interact with clients and prospective clients
- 'project space' where teams can collaborate, explore ideas and innovate
- a forum to promote the wellbeing of employees through social interaction – to combat the sense of isolation conferred by prolonged home working

In short, COVID-19 is unlikely to sound the death knell of the office as a hub to operate a business.

THE SERVICED & CO-WORKING OFFICE MARKET

Serviced & Co-Working Office Space

The rapid expansion of the serviced and co-working office sector in London throughout the last few years has resulted in overcapacity in the sector.

Even before the COVID-19 pandemic, evidence was gathering that all was not well in the serviced and co-working sector as leading providers quietly closed down some of their poorly-performing business centres. The funding issues being experienced by prominent co-working space provider, WeWork, are also well documented.

It is very likely that the trend towards rationalisation in the sector, that had started during Q1 2020, will continue for the foreseeable future, particularly given the vulnerability of serviced and co-working operators to rental income voids – a direct consequence of a business model predicated on offering short term lease flexibility to its customers.

Serviced and co-working space providers also have heavy exposure to start-up companies, particularly from the 'tech' sector - a significant proportion of which are vulnerable to having their venture capital funding withdrawn in a challenging business climate.

However, evidence is building up of a modest uptick in demand from the lockdown lows of several months ago as some occupiers take advantage of break options and lease expiries to downsize from their conventional office space, taking advantage of lower rents and the short term lease flexibility that serviced and co-working accommodation offers.

Serviced and co-working space also provides a quick, plug in and go, cash-flow friendly, workplace solution with no requirement to invest significant sums of working capital in an expensive fit out. There is also no stamp duty payable on the grant of a serviced / co-working agreement – in contrast to the grant of a lease on conventional office space.

"IT HAS BEEN RECENTLY REPORTED THAT THE RENTS BEING ACHIEVED ON SERVICED AND CO-WORKING SPACE LETTINGS DURING THE SUMMER MONTHS HAVE BEEN AT A DISCOUNT OF UP TO 20%"

But beware! If a move to serviced / co-working space is being considered, it would be prudent to carry out a financial health check on the provider of the selected space before parting with your rent deposit, given that the number of serviced and co-working space providers that cease trading, or that decide to close down under-performing business centres, is likely to rise over the coming months.

Serviced & Co-Working Office Rents

Rents in the serviced and co-working office sector across London are falling in the wake of increasing vacancy and weak demand, as competition hots up between providers for fewer footloose occupiers, compared with the beginning of the year.

It has been recently reported that the rents being achieved on serviced and co-working space lettings during the summer months have been at a discount of up to 20% compared with pre-COVID-19 rents – a trend that is likely to persist for the foreseeable future.

THE TENANT REPRESENTATION TEAM

Our tenant representation services include:

- Serviced & co-working property searches and negotiations
- Break option linked lease re-negotiation
- Workplace design & floorspace re-configuration
- Marketing & leasing services – surplus space
- Conventional office space search & cost appraisal
- Office move management
- Relocation budgeting & planning
- Lease & rent review negotiation
- Repairs/dilapidations cost assessment & negotiation
- Building, air conditioning & passenger lift surveys
- Business rates analysis & appeal
- Service charge audit

For more data on the London office market, office availability, rents & rent free periods, market trends & information on budgeting & planning for a lease renewal, rent review or office relocation please contact one of the team.

KEY CONTACTS

Michael Pain Partner
Head of Tenant Representation Team
07715 001013
michael.pain@carterjonas.co.uk

Daniel Francis Head of Research
07801 666137
daniel.francis@carterjonas.co.uk

Ed Caines Associate Partner
07966 188632
ed.caines@carterjonas.co.uk

Luke Wild Associate Partner
07780 667013
luke.wild@carterjonas.co.uk

Georgia Eckert Associate
07826 884704
georgia.eckert@carterjonas.co.uk

Anders Horwood Surveyor
07836 246049
anders.horwood@carterjonas.co.uk

One Chapel Place, London W1G 0BG

OUR EXPERIENCE

Lease negotiations and relocations 10,000 sq ft+

43,000 sq ft
UK Payments Administration
2 Thomas More Square, E1

39,000 sq ft
Care Quality Commission
151 Buckingham Palace Road, SW1

28,000 sq ft
Warner Bros/Shed Media
85 Grays Inn Road, WC1

27,000 sq ft
Reinsurance Group of America
22 Bishopsgate, EC2

17,500 sq ft
Hackett Limited
The Clove Building, SE1

16,000 sq ft
Circle Housing
Two Pancras Square, N1

15,000 sq ft
Hitachi Rail Europe
40 Holborn Viaduct, EC1

11,000 sq ft
Salamanca Group
50 Berkeley Street, W1