

# Central London Office Outlook H1 2022



# Occupational market

Leasing activity remained strong with occupier demand for best in class space continuing to drive transactions, despite economic headwinds

During the first half of this year, the Central London occupational market continued to experience strong levels of demand despite the increased uncertainty around the wider economy and rising cost pressures.

At the end of H1, take-up reached 5.2m sq ft, with a 3.1m sq ft completing in the second quarter. Overall take-up for H1 was up 13% on the long-term average, with occupier demand for best-in-class space, particularly from larger corporate occupiers, continuing to drive leasing activity. The higher level of demand for best-in-class space is reflected by the fact that 90% of space acquired so far this year has been of Grade A standard, up on a 10-year average of 81%; pre-lets have accounted for a third of this year's take-up.

There continues to be a clear preference for space with better sustainability credentials, with 53% of take-up being in BREEAM rated Excellent or Outstanding buildings.

Across Central London, there was a more even spread of take-up between the top three sectors with the Insurance & Financial sector accounting for 21%, followed by the Professional Services sector with 19% and Tech & Media with 17%.

In the City, we saw a continuation of the strong demand from Law firms. So far this year, the Professional Services sector has accounted for 29% of space let, with many firms upgrading their

current office for sustainability, brand perception or reasons related to the perceived benefits this new space will have on staff retention. Law firms have accounted for 43% of pre-letting activity in the City this year, the largest being Kirkland & Ellis' acquisition of the 19th to 34th floors (215,000 sq ft) at 40 Leadenhall, EC3 followed by Hogan Lovells at Royal London Asset Management's Holborn Viaduct development, EC1 (264,000 sq ft).

The growing preference for fitted space amongst smaller occupiers, which has been driven by cost, convenience and competition from serviced office offerings, has resulted in landlord fitted space accounting for 32% of sub 10,000 sq ft new leases that completed in the City, during H1.

In the West End, following five months of subdued leasing activity, a near-record 1.1m sq ft completed in the final month of the quarter. This was the third highest monthly take-up on record for the West End, with June take-up single-handedly accounting for 46% of H1 take-up. Notable transactions to complete included Capital International's pre-let of the 8th to 16th floors at the Sellar Group's Paddington Square development, W2 (220,000 sq ft), and the long-anticipated completion of MSD's acquisition of Belgrove House, WC1 (195,000 sq ft), which will form its new UK HQ and Discovery Centre. In total, there were five transactions sized over 50,000 sq ft, which was in line with the pre-Covid

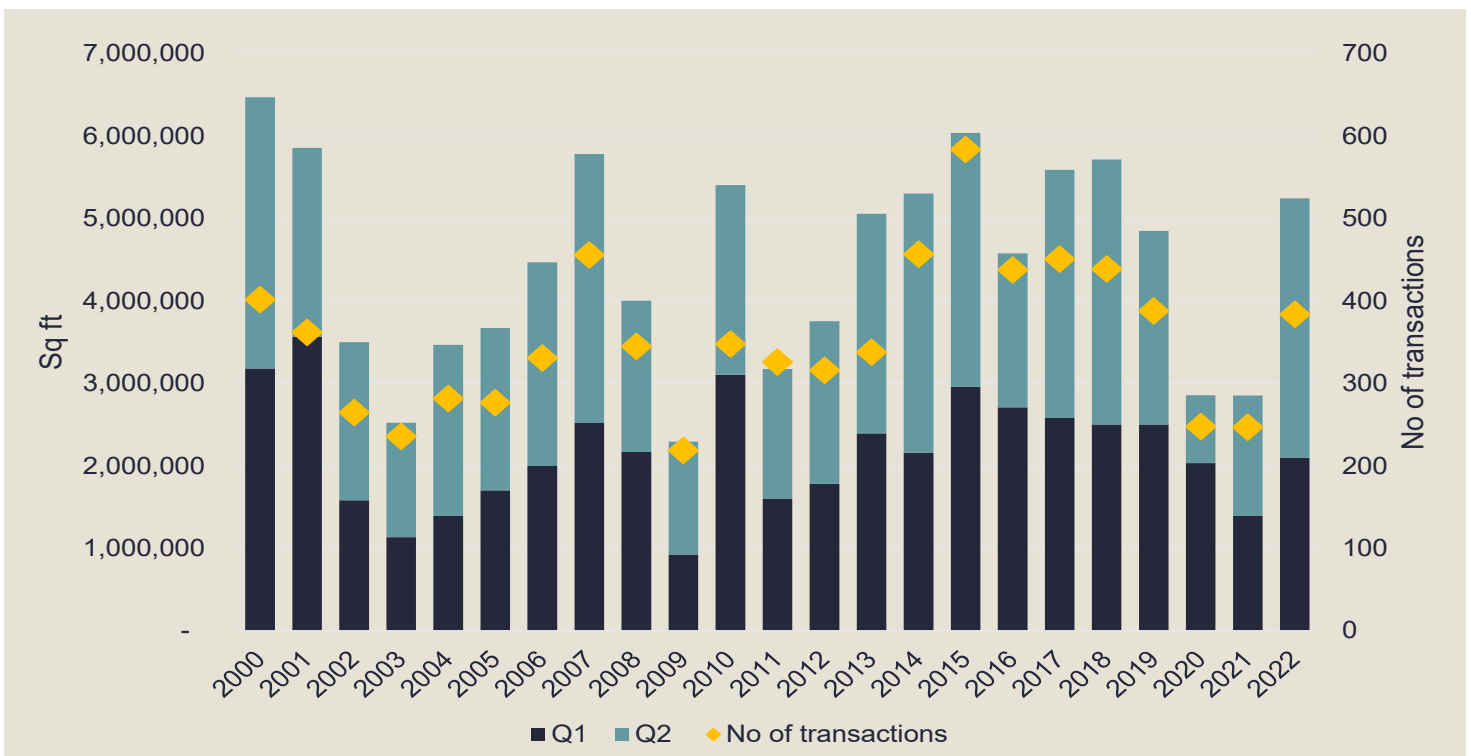
long-term average for H1.

In the West End, the Financial Services sector has been a significant source of demand and has accounted for 32% of space acquired so far this year. But focusing more specifically on the sub-sectors driving this activity in the West End, almost 66% of take-up to this sector is made up by acquisitions to Private Equity, Asset Management and Investment Management firms. This continues the trend seen in 2021, where the overall sq ft acquired and the number of transactions to this sub-sector reached a new record at 600,000 sq ft across 64 transactions.

The latest occupancy figures show the West End leading the way in terms of worker return to the office, with peak periods of the week, Tuesday to Thursday, now regularly recording occupancy levels over 40%, and the City following behind with 35%. This is compared to pre-pandemic occupancy levels which varied from 60-70%, varying across industry sectors.

Despite the fact that occupancy levels are reaching over half of what they were prior to the pandemic (assuming a pre-Covid occupancy level of around 65%), leasing activity has continued to remain strong with the impact of new working patterns and hybrid working on the whole not yet appearing to have a significant impact on the quantity of space occupiers are taking.

Figure 1: Central London H1 take-up



Source Savills Research



“The first half of 2022 has performed ahead of the long-term average and demonstrates resilience in Central London’s office market whilst reinforcing the important role that the office plays for businesses. Looking ahead, the clear global and domestic economic and political headwinds may well impact decision-making for businesses, but at the present time we are encouraged by the depth of demand in the market particularly for the very best product.”



**Jonathan Gardiner - Head of Central London Office Leasing**



**41%**

of occupiers are currently seeking to acquire a similar amount of space



**8.9m sq ft**

Central London active requirements are up 5% on the 5-year average



**7.6%**

The vacancy rate is down 50 bps on the previous quarter



**10m sq ft**

We are currently anticipating take-up will reach 10m sq ft in 2022

There continues to be little signs of occupiers changing the size of their requirements despite increasing cost pressures, but this could change in the second half of the year

Our analysis of occupiers who took 15,000 sq ft or more during H1 reveals that 40% of these occupiers were relocating to a similar-sized space in another building, a further 23% were relocating to new buildings and increasing their footprint by more than 20,000 sq ft, and only 11% had downsized.

This activity is broadly consistent with our analysis of current active Central London demand. The majority of occupiers (41%), who are currently actively looking for office space over 10,000 sq ft are seeking to acquire a similar amount of space, and there are more occupiers seeking to increase their footprint (29%) than those seeking to substantially reduce the amount of space they occupy (13%).

Looking forward, we expect full-year take-up to remain in line with the long-term average, reaching around 10m sq ft. Furthermore, with underlying demand continuing to remain high and employment forecasted to grow by 1.8% this year, the outlook looks encouraging. At the end of June, space under offer stood at 2.97m sq ft which was up 17% on the five-year average, and active requirements stood at 8.85m sq ft, up 5% on the five-year average.

And yet we cannot ignore the expected headwinds for the second half of this year, with inflationary pressures continuing to rise and the Bank of England currently forecasting a UK recession in Q4. This could have an impact of increasing occupier scrutiny on future space commitments and result in more cost-driven decisions being made for example occupiers compromising on a larger quantity of space and opting for less space but better quality space or opting for alternative locations vs compromising on quality.

As a result of the concentrated appetite for best-in-class space, alongside the lower levels of supply of this type of stock, we have continued to see average prime rents increase over the year. The average prime rent in the City at the end of H1 stood at £83.72 per sq ft, compared to £80.39 per sq ft at the end of H1 2021. The West End prime rent stood at £119.38 per sq ft, up 2% on the same period a year earlier. We are forecasting average prime rental growth of 3.3% per annum over the next five years as a result of sustained occupier demand for the very best product.

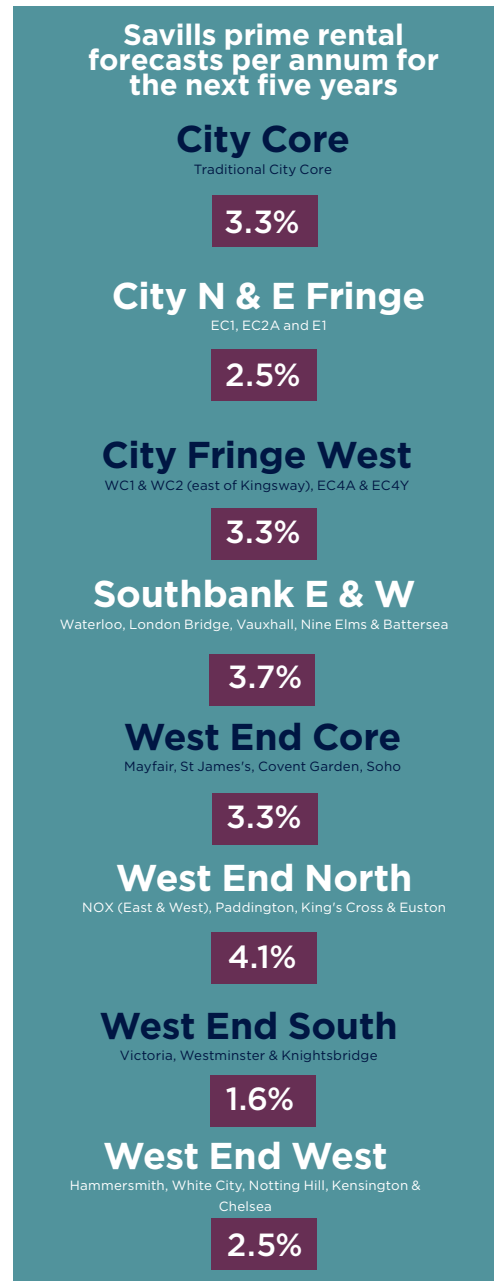
With the flurry of leasing activity and tenant controlled space falling for the seventh quarter in a row, we saw the largest downwards movement to the vacancy rate since Q4 2017. At the end of Q2, the vacancy rate stood at 7.6%, down 50 bps from 8.1% at the end of Q1, with overall supply standing at 19.6m sq ft.

The reduction to tenant controlled space over the quarter was mainly as a result of reductions in the West End, where tenant controlled space is almost at pre-pandemic levels, 1.3m sq ft compared to 1.1m sq ft at the end of Q1 2020. The City, by contrast, has seen tenant controlled space reduce by 10% since its post-pandemic peak level of 3.6m sq ft in October 2021. Although it is worth noting that 43% of City tenant controlled supply (by sq ft) is on a term of five years or less.

We expect the Central London vacancy rate at the end of the year to stay at 8.0%, with 4m sq ft scheduled to complete during the first half of 2023, which will be added to supply by Q4.

“Occupiers continue to want to acquire best-in-class space. This is against a backdrop of rising costs and the increased scrutiny occupiers are under in achieving sustainability accreditations to run their businesses, attract new talent, and to win clients. For the majority, environmental considerations remain the most significant part of ESG standards and part of the top criteria utilised by tenants in choosing their offices; alongside location, amenities, natural light, floorplate efficiency, and budget.”

**Paul Bennett, Tenant Representation, Central London Agency**



# Development

Development completions are currently set to hit a record level during 2023, though this will likely be tempered with increased pressure on project timescales

The buoyancy of the occupational market, coupled with the growing focus on improving energy efficiency, particularly with MEES coming into view over the next few years, has resulted in a robust development pipeline despite rising construction costs. We are anticipating development completions from now until the end of 2026 will reach 30.4m sq ft.

Already 18% of the new developments and extensive refurbishments expected to be delivered over the next four and a half years have been pre-let, and 5% of speculative space is currently known to be under offer. However, it is worth noting this is down from 22% at the end of H1 2020, where pre-lets over the same period accounted for 6.4m sq ft of the pipeline, compared to 4.8m sq ft at present.

Focusing on speculative space due for completion between now and 2026, the City Core accounts for the largest proportion with 28%, followed by SE1 with 14% and then by the City Fringe with 11%.

Six months ago we anticipated development completions for the first half of this year would reach 2.9m sq ft. However, by the end of the first half, only 62% of this actually reached completion. Increased pricing on materials and supply chain issues, as a result of wider macro trends, has kept upwards pressure on costs and project timescales, resulting in further expected delays.

This is reflected by the results of the latest Savills Programme and Cost Sentiment Survey (S.P.E.C.S) Q2 2022, which showed the sentiment around build costs and project timelines continue to remain at elevated levels, with most sectors seeing upwards pressure on costs and timescales and expecting this to continue over the next 12 months.

The continued high level of developer confidence and appetite for redevelopment opportunities is also reflected by the high levels of demand for land in Central London which has led to a 143% spike in commercial and mixed-use development transactions in H1 2022, compared to the same period last year, with £1.8bn trading year to date across 32 transactions. Looking ahead, currently, there is c.£1bn of development deals under offer and over £1bn of available stock being tracked across Central London. Though, we expect the inflationary and financing pressures to take some heat out of the market in the short term and result in this year's overall volume of development transactions falling shy of the recent annual average of c.£3.3bn.

The latest consensus figure on construction price inflation for this year currently stands at 6.1%, with almost all forecasts having been revised upwards over the quarter. This could have an impact on the future pipeline, with 70% of the space scheduled for delivery between 2024 and 2026 yet to start. It is therefore likely that

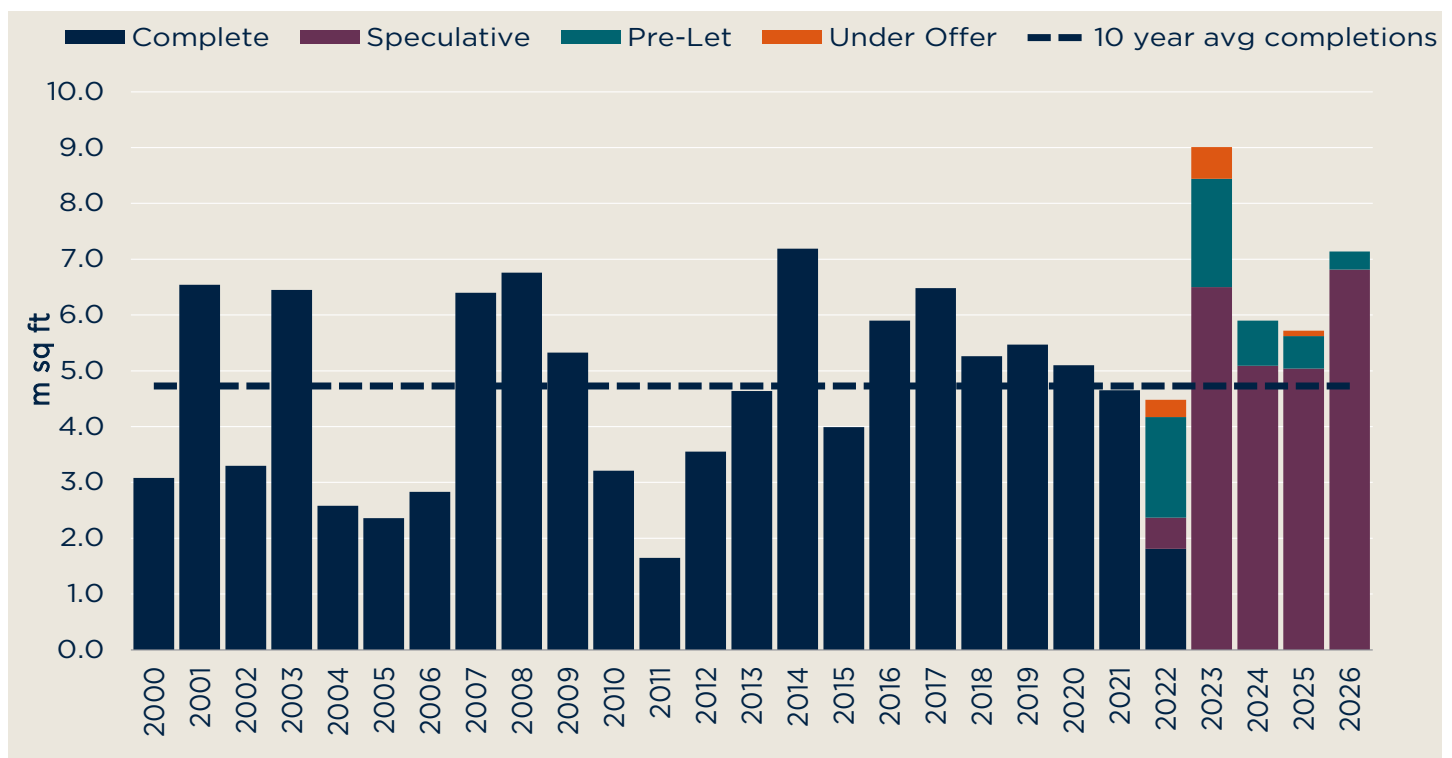
development completions for 2026 will be much lower than currently expected. We could also potentially see the start of more schemes being delayed until pricing pressures alleviate or the viability of more schemes being reappraised.

Notable schemes to complete over the first half of this year include 280 Bishopsgate, EC2 (260,000 sq ft) which is almost fully let; Bloom, Farringdon, EC1 (134,000 sq ft) also almost fully let; 16 Great Marlborough Street, W1 (105,000 sq ft) which was pre-let to Diageo.

Development activity across Central London is expected to reach a record 9m sq ft during 2023, with completions in the City on course to reach its highest level in over 30 years and the West End set to see a new record, just shy of 3.5m sq ft completing. However, in reality, this will likely reduce with almost a third of this expected to be delivered in Q4, increasing the likelihood that some of these schemes will be pushed out to 2024.

Some notable schemes due to complete during the second half of 2023 include 40 Leadenhall, EC3 (870,581 sq ft), 20 Ropemaker, EC2 (424,275 sq ft), Millennium Bridge House, EC4 (292,000 sq ft) and 21 Moorfields, EC2 (which is fully pre-let to Deutsche Bank). 22% of 2023's pipeline has been pre-let, and currently, a further 6% is under offer.

Figure 2: Central London Development Pipeline



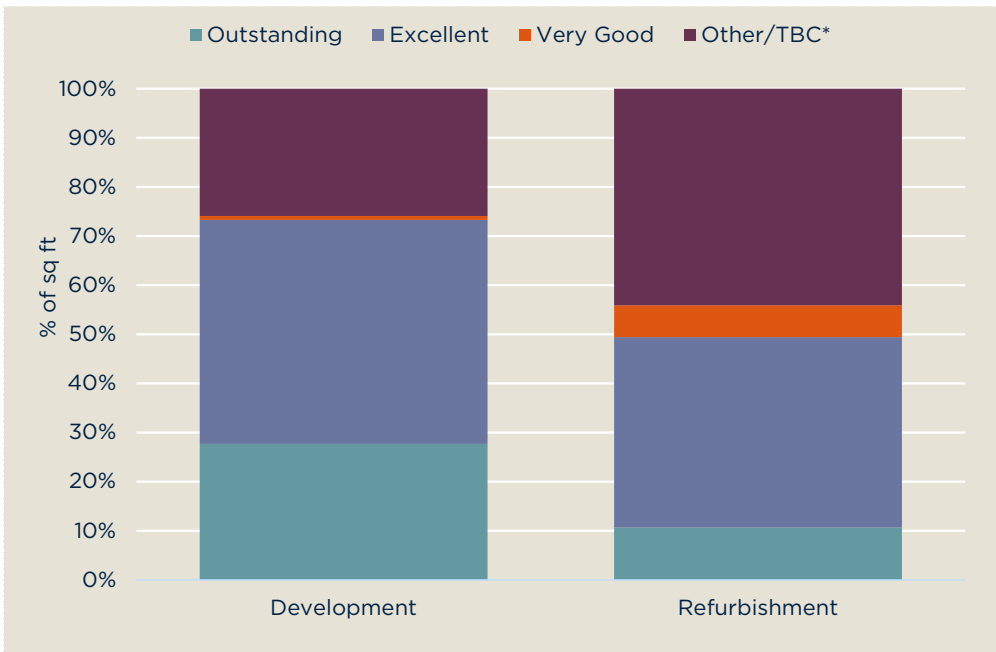
Source Savills Research

“H1 2022 was an exceptional time for the London land market. The current inflationary headwinds will remain a factor going forward, and whilst they will put some pressure on project viability, they have not come as a surprise and are countered to some extent by the positive occupational environment. In this context, the challenge for developers and landlords will remain the need to find a balance between delivering best-in-class space, but with the backdrop of a challenging regulatory and planning environment, and what it means for refurbishment and/or redevelopment of buildings.”



**Oliver Fursdon - Head of London Commercial Development**

**Figure 3: H2 2022-2026 Pipeline by BREEAM target**

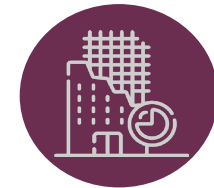


\* TBC represents schemes that are yet to announce what rating they are targeting

Source Savills Research



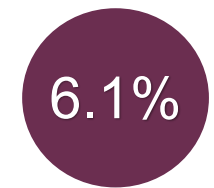
**55%**  
of schemes in the pipeline are targeting a BREEAM rating of Outstanding or Excellent



**13.6m sq ft**  
is currently under construction



**9m sq ft**  
is currently scheduled for delivery during 2023



**6.1%**  
Construction price inflation forecasts for 2022 are up from initial estimate of 3.8% at the start of the year

There has been a significant increase in the number of schemes that are aiming to achieve better sustainability credentials. By sq ft, the proportion of schemes in the pipeline targeting BREEAM Outstanding and Excellent now account for almost two-thirds of the space being delivered. Whilst new developments account for 66% of the overall sq ft that will be delivered, there is an even split by number of schemes, with 49% of the current pipeline consisting of extensive refurbishments.

At present 19% of new schemes (by number) scheduled for delivery between now and 2026 are currently known to be targeting a BREEAM rating of Outstanding, a further 49% are targeting Excellent, and 3% are targeting Very Good.

In comparison, 40% of refurbishments (by number), are now targeting a BREEAM rating of Excellent or Outstanding. This is up 15% on the number of refurbishments we recorded at this point last year that were targeting a BREEAM rating of Excellent or Outstanding, giving some early indication of a growing preference for retrofitting and sustainably refurbishing, as a result of the growing awareness of embodied carbon.

Whilst we are expecting to see more investors considering refurbishment options, new builds will still remain necessary where a whole-life carbon benefit and improved efficiency can be better achieved.

In the past, we have seen strong tenant demand result in high levels of pre-letting activity across Central London, with pre-letting accounting for around a quarter of leasing activity over the past five years. And with occupiers viewing their future space commitments as a tool for working towards their own net zero targets, three-quarters of space that has been pre-let since the pandemic has been BREEAM rated Excellent or Outstanding.

The importance of sustainability and reducing carbon emissions in office space, and the understanding of how to achieve these objectives, will continue to mature, as we expect the focus on the energy in use and efficiency measurements to grow as EPCs give way to measures that monitor actual energy usage, such as DEC or NABERS.

# Investment

H1 turnover reaches £9bn despite rising macro pressures, though Q2 activity was subdued as a result of market volatility

Positive momentum in the market at the end of 2021, and the continued strong investor appetite we saw during this period, resulted in Central London investment turnover for the first quarter reaching £6.1bn, with around 70 assets trading. This was a new record for a Q1 period, with the freehold interest in UBS's headquarters at 5 Broadgate, EC2 being acquired by LaSalle Investment Management, on behalf of NPS, for £1.2bn and Google's freehold acquisition of Central Saint Giles, WC2 for £773m, exchanging.

However, since then, there has been a substantial shift in the economic outlook with the ongoing conflict in Ukraine, inflation currently forecasted to reach 13% by the end of the year with the rise in the energy price cap and a forecasted protracted recession and the resulting increasing interest rates, build costs and increased cost of debt. Within a 12-month period, the five-year SONIA swap increased from 0.47% in June 2021 to 2.6% at the end of June, having peaked at 2.8%. (Though this has now come down and is at c.2.4% at present).

The volatility in rates limited the number of market participants, particularly those debt-backed buyers, and as a result of the higher levels of uncertainty, we saw a subdued level of activity over the second quarter, with turnover reaching £2.88bn. This was down 48% on the previous quarter and 28% on the long-term Q2 average.

Despite the lower level of activity we saw in Q2, investment turnover at the end of the first half stood at £9bn, which was up 30% on the 10-year long-term average. The largest transaction to complete during Q2 was GIC's acquisition of a 75% stake in Paddington Central, W2 from British Land (who retain the remaining 25% share) for a reported £694m (purchase reflecting a 4.50% NIY and £1,224 psf across a range of assets). In another transaction of note, which Savills advised on, on behalf of a private Asia Pacific investor, was the acquisition of 2 London Wall Place, EC2, (pricing remains confidential).

Overall, international investors continued to be the main driver of activity and accounted for 77% of H1 turnover. We saw the return of Asian investors during H1 and they accounted for 40% of turnover, this is up from 17% at the end of H1 2021. UK investors followed with a 23% share, followed by European investors, who we have seen muted activity from over the first half of the year, with 6%.

Institutional investors accounted for 43% of H1 turnover, which was up 6% on the same period a year earlier. Investment activity in the City, historically, has been driven by a greater volume of institutional money, with institutional investors having accounted for 40% of turnover since 2016 in comparison to the West End, where private investors have accounted for the largest share, 35%

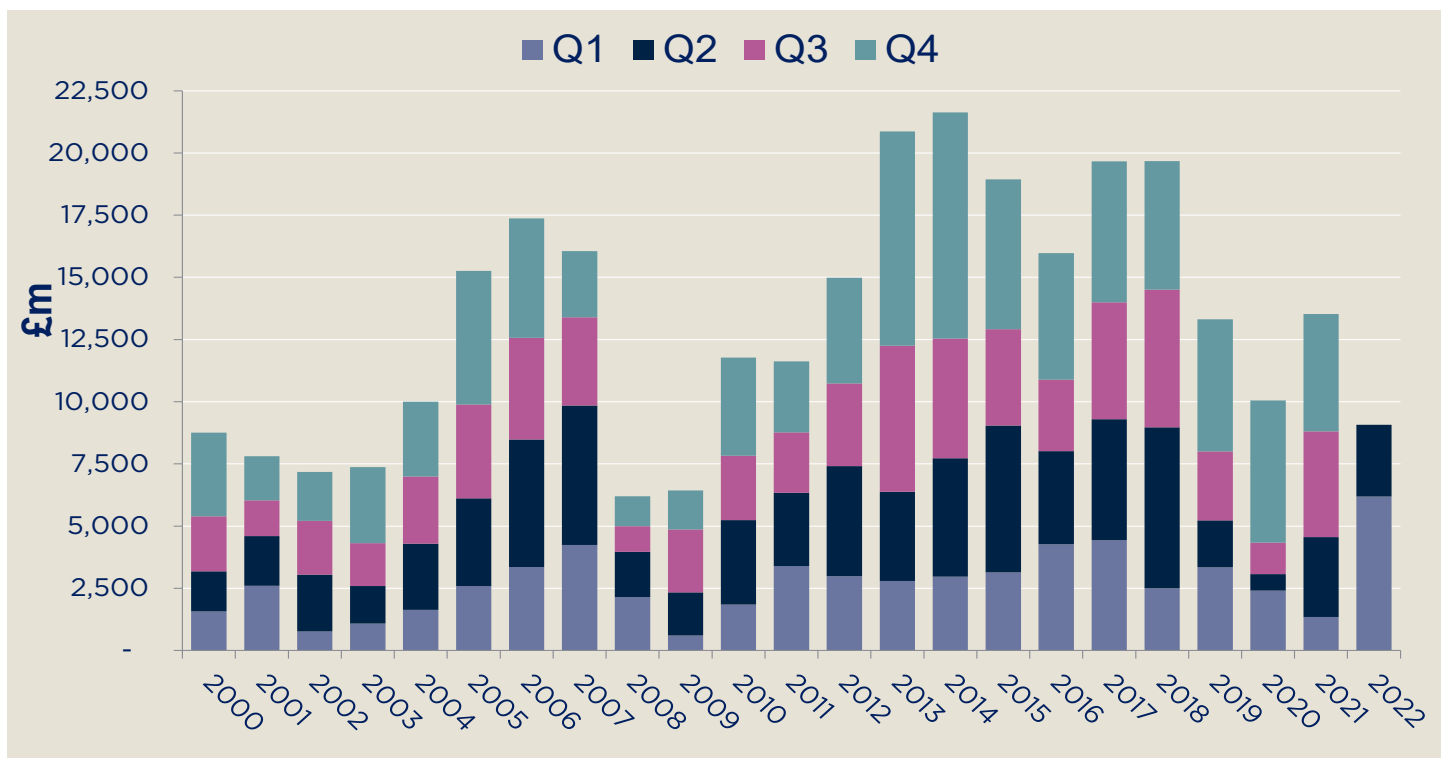
of turnover (followed by institutional investors with 25%).

Whilst a reasonable volume (just above the five-year average) of transactions completed, overall capital continues to be heavily weighted towards the bigger lot sizes, with £100m+ transactions accounting for 80% of the volume to complete so far this year.

Despite the headwinds, at the end of June we were tracking purchasable stock on the market at £7bn, up 22% on the volume at the end of the same period last year. The volume of stock under offer was also at a high level at £5bn, with the weight of under offers also heavily weighted towards the larger-sized lots, with the £100m+ lot size accounting for 76% of turnover under offer across 12 assets at the end of June.

Encouragingly during the past month since the end of H1, we have witnessed an unprecedented level of investment activity in the West End in contrast with the traditional lull in activity during the summer months. As a result of the high level of activity in the West End, Central London July turnover has reached £1.1bn. Further to this, the volume of stock under offer continues to remain at £5bn, and available stock has increased to £7.7bn.

Figure 4: Central London Investment turnover by quarter



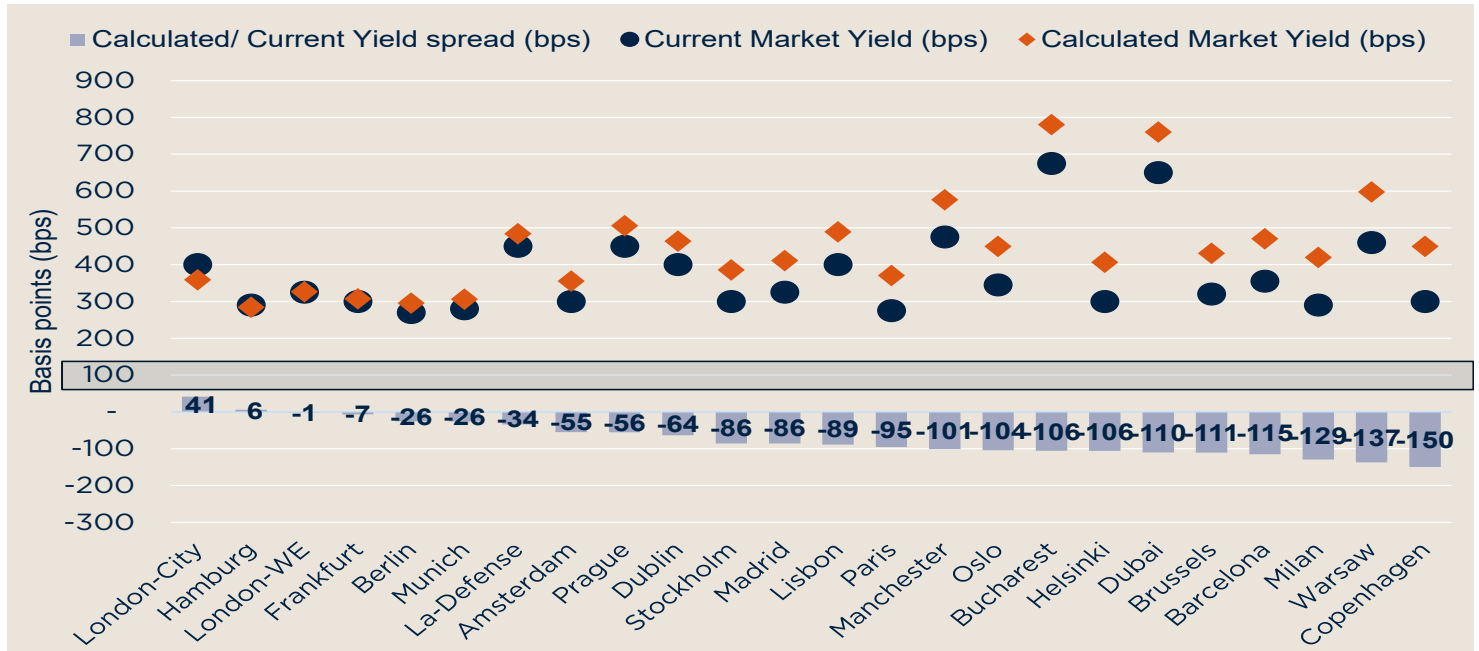
Source Savills Research

“With a good handful of landmark transactions driving investment volumes for H1, all eyes are on the larger deals under offer and in the market for the second half of the year. The rapid increase in interest rates spiked market uncertainty which quickly fed through to purchaser confidence and pricing. However, as London’s office leasing story remains robust and as debt rates have come back in, plus the benefit of more favourable sterling for the overseas buyers, we are starting to see the bid-ask spread narrow and more opportunist bidders being replaced by groups seeking to take advantage of a less competitive market place.”



**Richard Garside - Head of Central London Investment**

**Figure 5: EME Office Value Analysis**



**Methodology**

Savills EME Office Value Analysis compares the fair-market (calculated) yield relative to current market pricing across 24 EME markets. An investor must be compensated for bearing the risk of investing in real estate over sovereign bonds. The calculated yield is derived as the current risk-free rate plus five-year average office risk premium, discounting for nominal rental growth, inflation and expected depreciation forecasts across each market. The calculated yield represents a hypothetical yield assuming a fully liquid market and that the investor is fully hedged against currency risk. Calculated market yield pricing >50 basis points above market pricing we consider under-priced. Calculated market yield pricing within 50 bps of market pricing we consider fairly priced

We will be closely tracking the assets which are currently under offer as the outcome will set a strong precedent for pricing of new sales during the second half of this year. Going forward, we expect to see investor appetite tempering with the higher than average levels of inflation and increasing cost of debt financing remain at the forefront of investors’ minds but the focus on Core long income secure assets, and for office buildings with high green credentials, and demand for these assets to support pricing of best-in-class assets.

The West End Prime yield remains stable at 3.25%, but we moved the London City prime yield out by 25 bps to 4.0% at the end of Q2, although the outlook for the next 12 months is a little more encouraging as we are starting to see investors’ focus turn to the depreciation in GBP, which has lost around 13% in value against the USD since the beginning of the year, and 5% against a basket of the UK’s major trading partners vs a number of major global currencies including HKD (9.29) and USD (1.18) as an opportunity for cash buyers who are looking to

deploy capital at a historically attractive rate. The consensus is for the pound to end 2022 at USD 1.24 per GBP and 2023 at USD 1.30 per GBP.

London’s reputation as a global city has kept it attractive to investors worldwide, particularly as risk premiums are currently attractive compared to other European and global gateway cities. Although the average European yield was up 20 bps, at 3.7%, from 3.5%, with most European city office yields holding firm or moving out during Q2 2022, as we saw debt cost continue to rise across European markets, for example, total debt costs in Frankfurt, Madrid, and Paris moved out 120-140 bps on the previous quarter.

London City and West End prime yields remained in the fairly priced territory in our Q2 European value analysis, supported by forecasted real rental growth over the next five years. Investors will be paying close attention to how inflation will impact interest rates over the next 12 months and how this will impact debt terms on refinancing in 2023.

4.00%

City prime yield

3.25%

West End prime yield





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### Savills Commercial Research

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