The Occupier Brief – London Office Market H2 2021

Hallett

DATA DRIVEN DECISIONS

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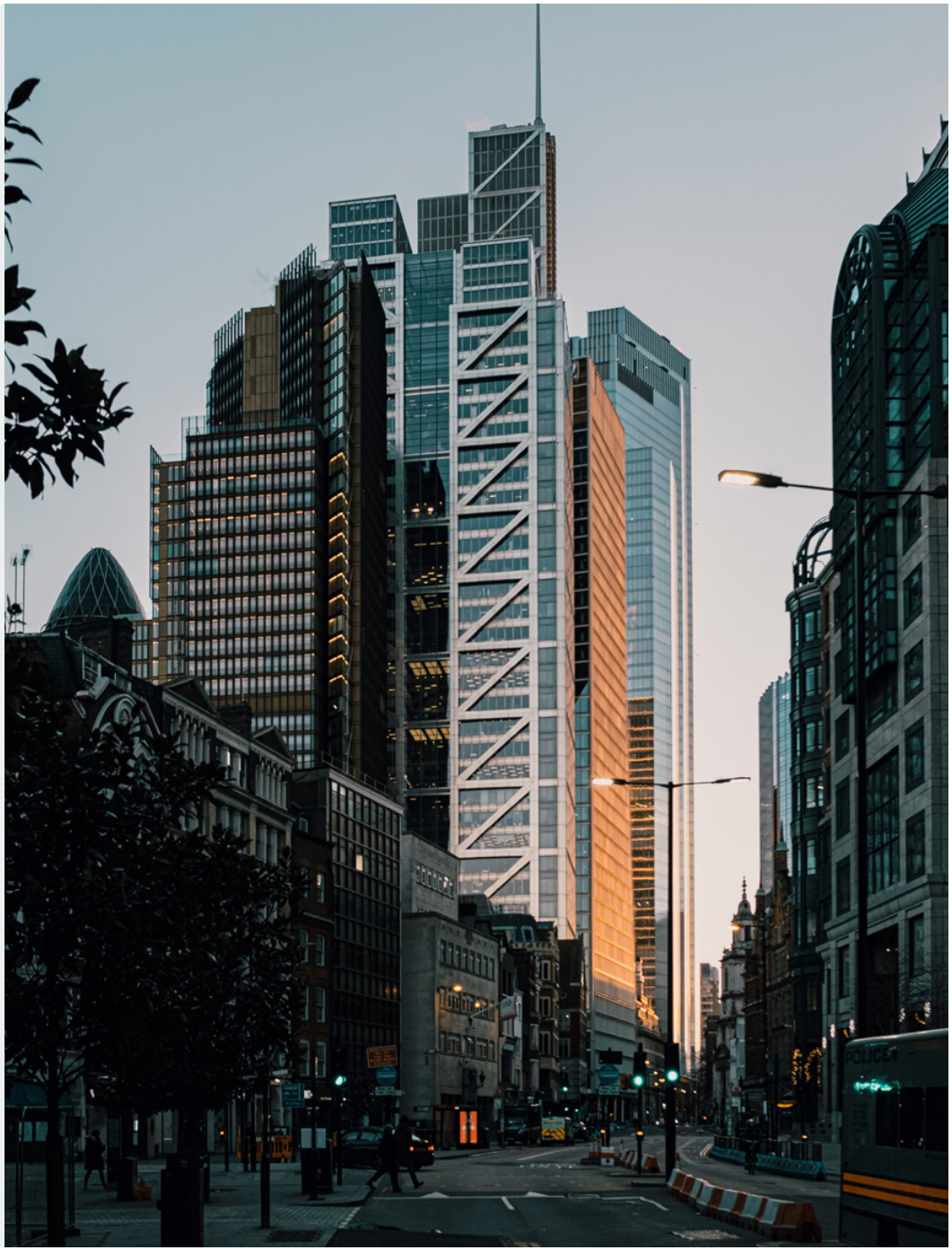
Market summary

After a quiet summer, September 2021 saw the busiest month for office leasing in London in two years. A noticeable uptick in office demand and a steady week on week increase in the number of staff attending their place of work (up to 22% in the week ending 15 October 2021) are both positive indicators of recovery. However, the London office market is ever vulnerable to economic uncertainty. The prospects of inflation, rising interest rates and the re-introduction of Covid restrictions are likely to suppress office leasing activity.

This, along with the supply of Central London office stock, which already far outstripped demand, continuing to increase, suggests that the London office market still has a difficult 12 to 18 months ahead.

Buildings offering the latest specifications, wellness features and green credentials will continue to perform better than poorer quality buildings, as companies use their offices as a way to tempt staff back into the workplace, as a recruitment and retention tool and as a way to boost staff productivity and wellness.



Key trends

Rents

Quoting rents have remained surprisingly stable since the start of the pandemic with Landlords opting to hold out in the hope that the market recovers rather than reduce quoting rents as a short term fix. However, discounts that can be negotiated off quoting rents have increased significantly from circa 1.5 – 3% pre-Covid to between 5 – 10%. Over the next 6 – 12 months, certain markets such as the City of London, City fringe and Canary Wharf are likely to see quoting rents fall for Grade B (poorly specified / secondhand) office space which has high volumes of supply and low demand. Quoting rents for the best quality Grade A (well specified new / refurbished) office space may increase slightly, particularly in areas where supply is lower, such as the West End.

Rent free periods

During the height of Covid rent free periods increased from pre-pandemic levels of 10 – 12 months over a 5 year lease term, to up to 15 months over a 5 year lease term, and in some exceptional cases up to 18 months for Grade B office stock. Signs are that rent free periods may be starting to shrink for Grade A office stock, but otherwise are likely to remain stable for the next 6 – 12 months.

City vs West End

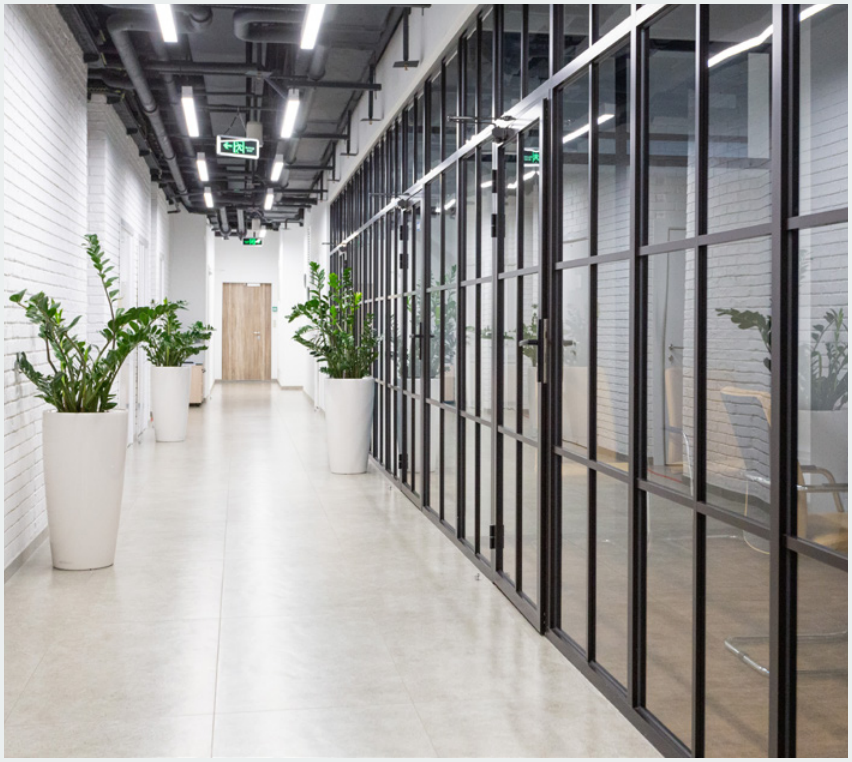
The disparity between the City and West End office markets has grown. Vacancy rates in the City, Canary Wharf and City fringe are considerably higher than the West End, driven by a number of large new office developments being brought on to the market (e.g. 2 Gresham Street – c.180,000 sq ft / 22 Bishopsgate – c.450,000 sq ft / 1 Portsoken Street – c. 240,000 sq ft, HYLO – c.240,000 sq ft / 20 Canada Square – c.230,000 sq ft / 30 Churchill Place – c.285,000 sq ft / 40 Bank Street – c.200,000 sq ft), but without the requisite demand to fill them. The level of supply in the West End is generally more constrained, and so we expect here that rents will remain relatively stable over the next 6 – 12 months. Due to the high levels of supply, the City market will be more susceptible to rents falling, particularly for Grade B office stock (see below – two tier market).

Two tier market

The difference between the Grade A (well specified new / refurbished office space) & Grade B (poorly specified / secondhand office space) office tiers is growing. Since the onset of Covid-19, the office is now seen not only as a tool for recruitment and increasing staff productivity, but also as a way to tempt staff back into the office. For this reason, companies are gravitating towards better quality office space with market leading specifications, wellness features and green credentials to provide the best possible working environments for staff. There are now fewer firms willing to accept poor quality office space, despite such spaces being offered at discounted rents, and so demand for Grade B office space has fallen (and is likely to continue falling) further.

Deferred decisions

Our research shows that, despite staff now beginning to return to the workplace, many companies are still not sure of how much office space they will require 6 – 12 months from now. For many, it is still too early to decide how many permanent desks, and hence how big an office, they will require, particularly given the negative implications of committing to offices which are too large (cost) or too small (productivity). Where possible, such companies are deferring real estate decisions until 2022 when they hope to have a better understanding of their floorspace requirements, or are choosing to use serviced or managed offices as a short term stop gap.



The hybrid model

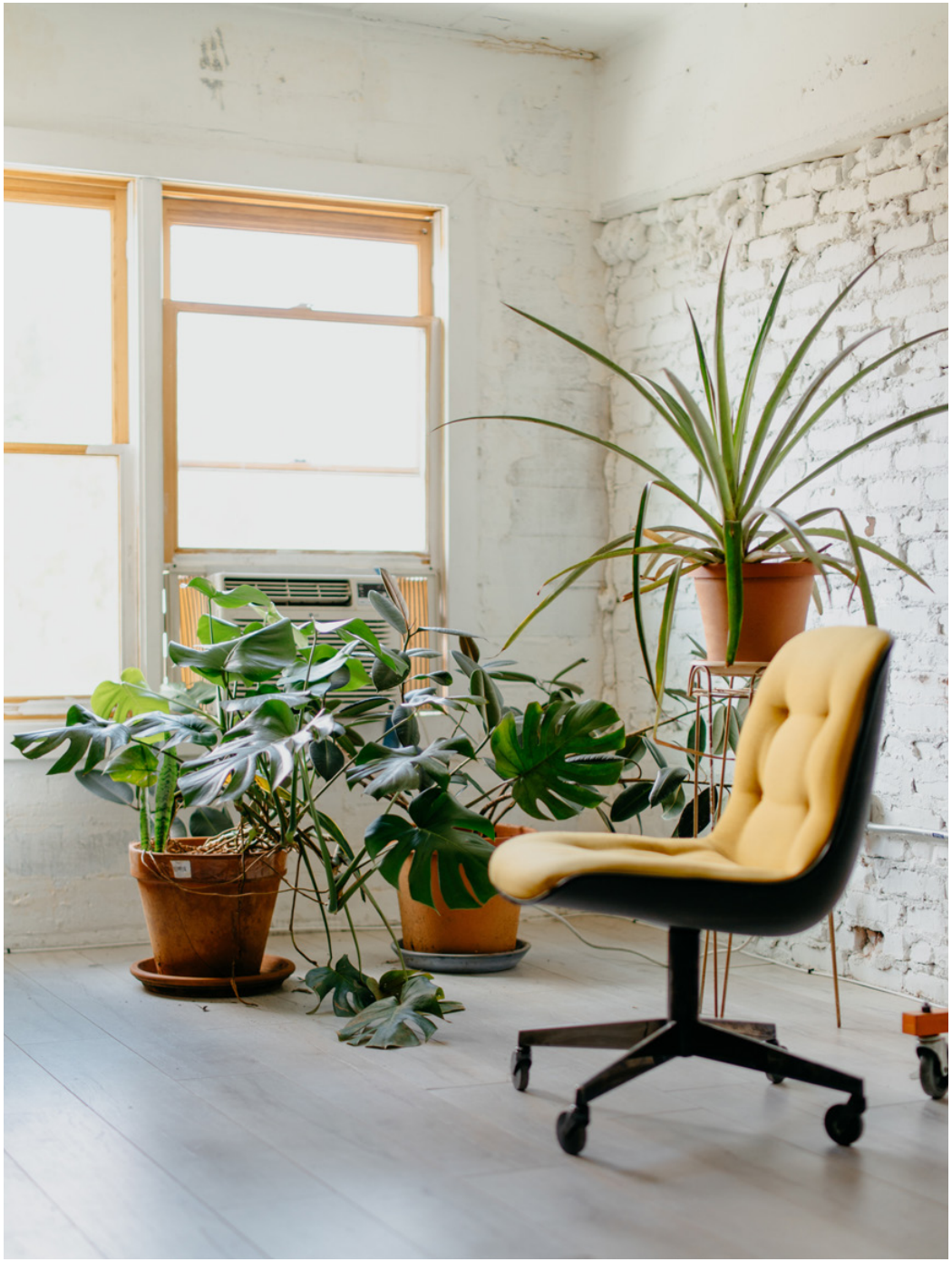
With the gradual return of staff to the workplace, a number of organisations are now trialling a hybrid model that allows staff to work from home 1 – 3 days per week. There is potential for tenants to capture savings by downsizing to smaller premises if the number of permanent desks can be reduced. However, the impact of the hybrid model on productivity is not yet fully understood, and the challenge is to implement a system which ensures that staff work from home on differing days, as opposed to just Monday and Friday. A desk booking system is a common solution and many new / comprehensively refurbished office buildings are now providing their own building apps which can be used by staff to book desk space.

Types of occupancy

The past 24 months has seen the types of occupancy available to tenants grow from either 'conventionalleasehold' or 'serviced', to include a range of options catering for different tenant requirements and budget considerations. Please see the 'Types of Occupancy' table overleaf which summarises the various options currently available to tenants.

The serviced 'Hub & Spoke' model

One growing trend is that of larger companies choosing to move from conventional leasehold offices to serviced offices on a 'Hub & Spoke' model, as a way of reducing occupancy costs and also to appeal to staff with challenging commutes. This model is based on the company moving to a smaller dedicated private serviced or managed office in one central location, but with staff also being able to use co-working space in other serviced office centres within the providers portfolio on a membership basis. Larger serviced office providers with multiple locations (Regus, The Office Group, WeWork, Spaceworks etc) are benefitting by being able to cater for this model.



Predictions for the next 12 months

Rents and rent free periods – with the two tier (Grade A v Grade B) gap widening, rents for Grade A office stock are likely to remain stable whilst rents for Grade B office stock might fall by as much as 5 – 10%. Rents for the highest quality, new Grade A office stock may actually increase, as any demand is drawn towards the very best space. Rent free periods are likely to remain stable for both Grade A and Grade B office stock, having reached record levels during the height of the pandemic.

Evolving hybrid model – the hybrid model, where staff work from home 1 – 3 days per week, may tighten up as companies push to get staff back into the workplace. However, working from home will remain for the foreseeable future as companies will be required to offer flexible working to promote wellbeing and to aid in staff recruitment and retention. A 'market norm' may develop where most companies offer employees the ability to work from home 1 – 2 days per week.

Serviced / managed – serviced and managed offices will see an increase in demand as tenants use the flex sector as a short term stop-gap until there is more certainty on floor area requirements, or, as a longer term solution which adopts the serviced hub & spoke model to appeal to footloose staff.

Pre-fitted space – office space that is offered pre-fitted, either Cat A+ or as a managed solution, is likely to become more commonplace as Landlords try to tempt tenants by offering solutions that require lower up front capital expenditure and reduced exit costs.

Opportunities for tenants

- The deal terms that can be achieved across all office types (leasehold, serviced & managed) are still highly competitive when compared with pre-Covid terms
- Office tenants now have a range of occupancy options (see Types of Occupancy table overleaf) offering different contract lengths,
- Where tenants are unsure of the amount of floor space they require over the next 6 – 12 months, managed offices allow tenants to replicate the leasing model but on very flexible lease terms and with low capital-expenditure outlay, acting as a viable short term stop-gap.
- Tenants with an upcoming lease event (e.g. break option or lease expiry) can still use these very effectively as leverage to reduce costs by negotiating more attractive lease terms
- Where there is an outstanding or upcoming rent review, current market conditions are such that in many cases a nil rent increase will be justified. We recommend that tenants contact their property consultant to discuss the best strategy to implement to achieve a nil rent increase and obtain certainty over future rental coats.

Types of occupancy

Type of Space	Typical Contract	Typical Contract Length	Typical Company Size	Description
Conventional				
Shell & Core	Lease	5 years +	100 +	Space provided with only the structural wall, ceiling and the building core. Typically for larger organisations who want control over the remaining finishes, such as set up of the A/C system, suspended / exposed ceiling and the flooring
Cat A	Lease	2 years +	10 +	Refurbished office space with ceiling, flooring, lighting and WC's installed. Cat A space is provided in a completely open plan condition, ready for the tenant to add its own bespoke fit-out
Fitted				
Cat B / fully fitted or plug & play	Lease	2 years +	10 +	Space with a full fit-out already in situ, including meeting rooms, kitchen, break-out areas, furniture and IT, either offered by an existing tenant (Cat B) or by a Landlord who has fitted out the space speculatively (fully fitted or plug & play)
Cat A +	Lease	2 years +	10 +	Space that has had circa 60 – 90% of the fit-out already installed speculatively by the Landlord in order to attract tenants, but with the remainder to be finished by the tenant based on their requirements
Serviced				
Co-working	Licence	Monthly rolling	1-5	A shared working environment in a communal area with either a fixed or hot desking arrangement, with shared access to kitchen, breakout and meeting room facilities
Serviced	Licence	3-24 months	1-200	A designated office with a set number of desks and sometimes internal meeting rooms, all pre-installed by the Landlord, typically within a larger floor or building that has shared use of kitchen, breakout and meeting room facilities.
Managed	Short form lease or licence	2-5 years	20-200	Usually a single self-contained office floor that has been fully fitted by the Landlord to include meeting rooms, kitchen, break-out areas, furniture and IT. Additional serviced such as utilities, cleaning, maintenance are included in a fully inclusive monthly rent

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