cluttons.com

CLUTTONS

UK OFFICE LEASING

Q2 REVIEW

RICS

UK OFFICE LEASING

CORONAVIRUS LEADS TO DRAMATIC DECLINES IN LEASING ACTIVITY

The office market – like the rest of the UK economy – is going through unprecedented times. Economic output is estimated to have shrunk 20.4% during the second quarter. Quarterly falls during the Global Financial Crisis were just a tenth of that level. Commuter trains remain relatively quiet and offices are still under-occupied, despite calls by the government to encourage people to return to the workplace.

UK office leasing activity was just below 4.5m sq ft in the second quarter—almost 70% less than the five year quarterly average. In Central London, activity was 74% lower than average. The West End saw a 72% fall in leasing activity, and the City and Southbank both experienced declines of more than 80%.

At the end of May, as lockdown restrictions eased, there were increased enquiries for office space. This suggests a potential future uptick in leasing activity. While this appears encouraging, there remain many occupiers unwilling to commit to signing a lease.

> “The recovery of enquiries between London agents towards the end of May continued progressively to stand at just under 80% of pre-Coronavirus levels, before tailing off as we entered the summer holiday season.
>
> However, the limited data available suggests that tenants committing to signing a lease is 30-40% of pre-lockdown levels which means a significant proportion of those looking are effectively on hold.”
>
> Ralph Pearson, Office Agency

The South East[1] was impacted similarly to Central London. But the M25 West office market – which includes Heathrow, Slough, Staines, Maidenhead, Bracknell and Reading – has been more resilient. Some regional office markets, including Sheffield, Newcastle and Glasgow also fared better than the UK average (Table 1).

TABLE 1: QUARTERLY OFFICE LEASING ACTIVITY IN SQ FT VS 5-YEAR AVERAGE TO Q2 2020

	TOTAL OFFICE INVESTMENT ACTIVITY IN £MLNS					Q2 2020	
	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	5-yr avg	vs 5yr avg
UK	**12,874,080**	**11,830,862**	**11,073,016**	**8,032,469**	**4,496,177**	**14,208,035**	**-68.4%**
Central London	**4,311,136**	**4,865,922**	**4,625,863**	**2,944,455**	**1,325,898**	**5,142,661**	**-74.2%**
West End	1,680,779	1,948,084	1,374,053	1,148,858	606,423	2,154,625	-71.9%
City	1,904,945	2,381,013	2,800,687	1,555,779	388,947	2,255,900	-82.8%
Southbank	212,956	100,851	199,272	214,845	61,877	347,229	-82.2%
Docklands	512,456	435,974	251,851	24,973	268,651	384,907	-30.2%
M25 West	**512,456**	**435,974**	**251,851**	**24,973**	**268,651**	**384,907**	**-30.2%**
South East	**1,542,999**	**1,291,818**	**998,636**	**713,848**	**481,022**	**1,732,849**	**-72.2%**
Regional cities	**3,647,213**	**2,584,768**	**2,759,211**	**2,232,679**	**1,260,954**	**3,637,417**	**-65.3%**
Birmingham	551,529	263,417	310,996	394,909	189,450	565,343	-66.5%
Bristol	333,984	210,924	383,828	265,978	86,358	337,547	-74.4%
Edinburgh	206,761	198,359	284,533	79,733	18,069	248,152	-92.7%
Glasgow	318,654	281,422	318,968	289,630	249,718	416,495	-40.0%
Leeds	440,228	323,420	401,843	198,206	186,714	468,897	-60.2%
Liverpool	129,370	177,301	158,725	45,992	36,643	199,166	-81.6%
Manchester	894,555	627,300	609,236	599,637	93,127	723,481	-87.1%
Newcastle	346,823	170,002	44,722	176,698	151,729	201,039	-24.5%
Oxford	105,743	191,603	94,949	58,741	15,533	157,621	-90.1%
Sheffield	256,327	75,470	119,726	45,219	176,673	181,597	-2.7%

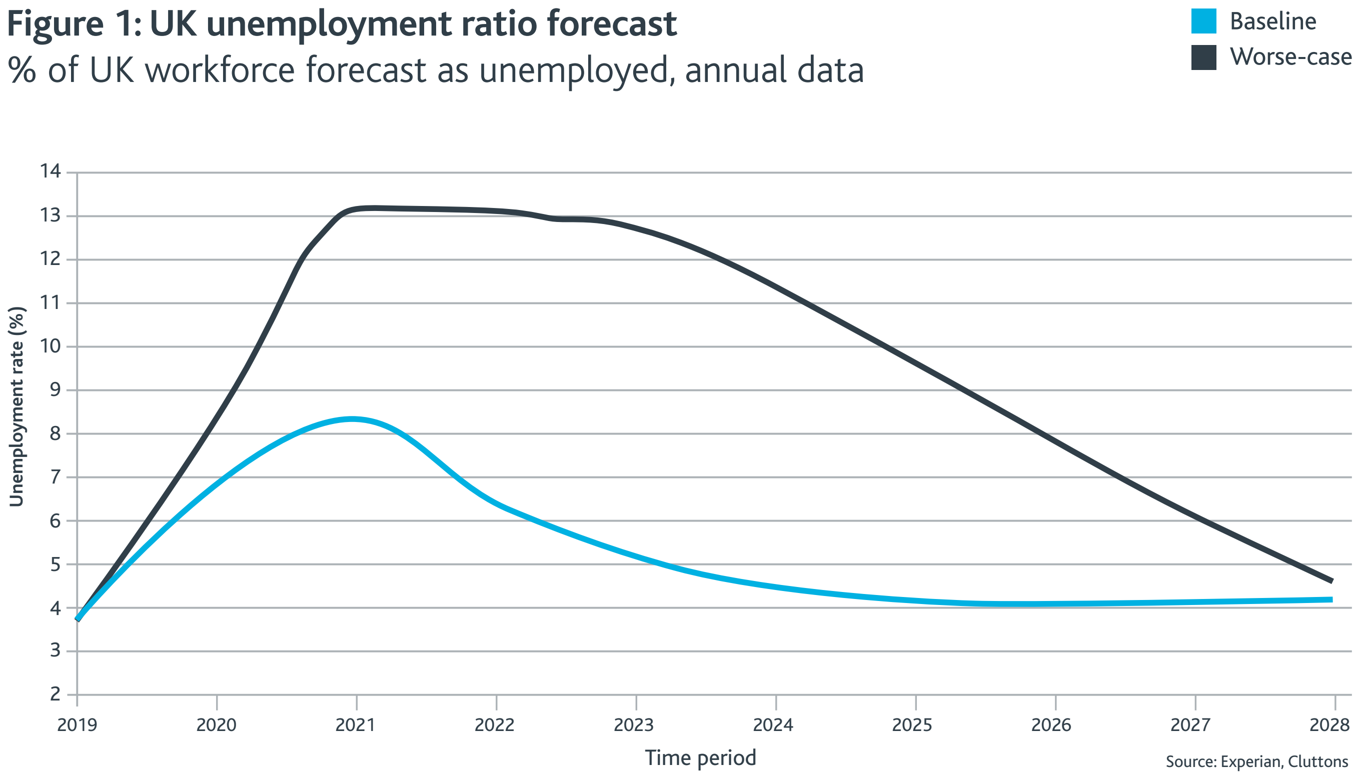
Source: Cluttons

The recovery of the office market depends on a range of factors, among them the COVID-19 pandemic being brought under control, and a favourable trade deal being struck with the European Union by the end of the year. Of general importance are levels of government support for businesses and levels of business confidence. Both will impact investment, economic growth and, in turn, office demand.

RICS

Figure 1: UK unemployment ratio forecast

% of UK workforce forecast as unemployed, annual data



Source: Experian, Cluttons

UNEMPLOYMENT TO IMPACT OFFICE DEMAND

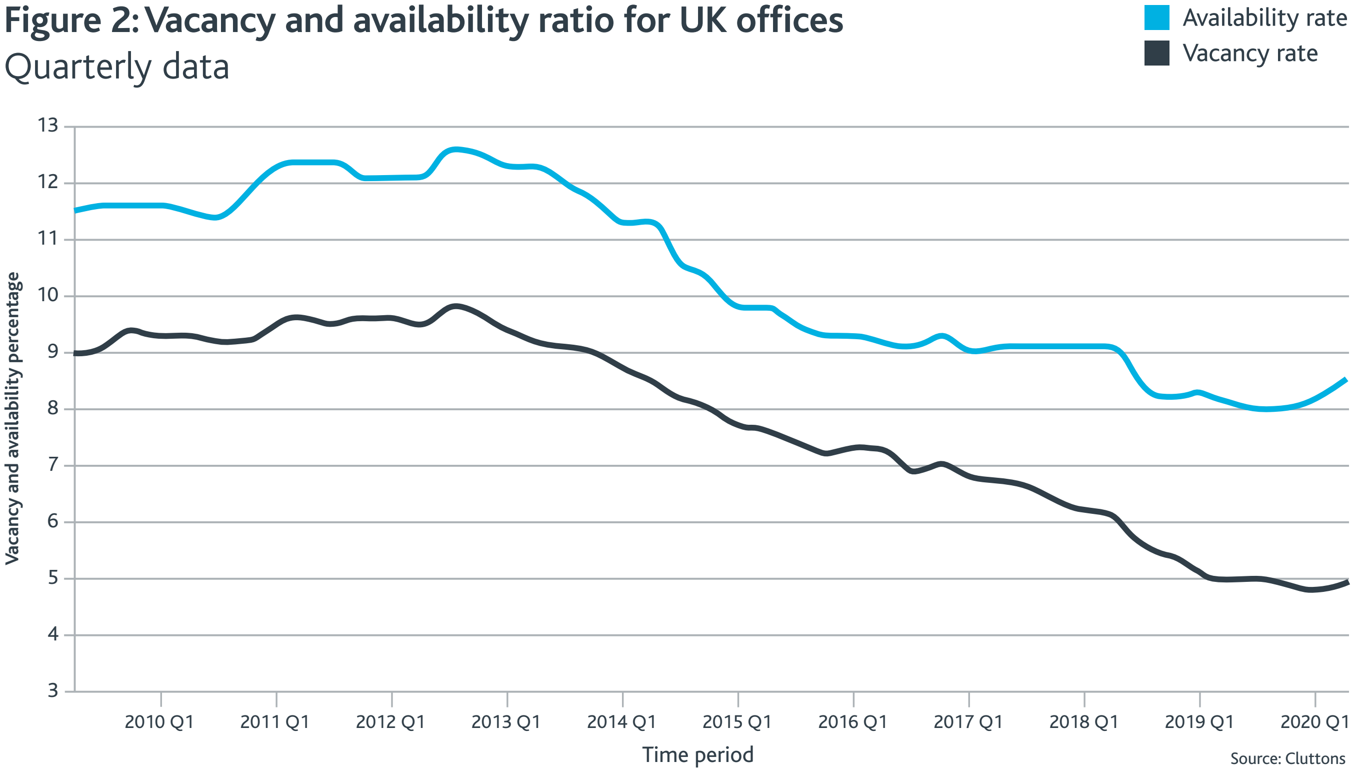
Many (ordinarily) desk-based jobs are currently being done from home, meaning offices are suffering from low occupancy. As lockdown behaviours ease and restrictions loosen, offices should see occupancy rise—particularly in less densely populated areas where workers face less arduous commutes.

The level and type of demand for office space going forward is unknown. Plans differ from business to business and many companies do not yet have a set target for a gradual return to the office. Even when they do, a higher degree of working from home will remain. Lower densities mean businesses will require more square footage per employee, and many offices will lose 50%+ of their capacity. With more space needed per employee than previously, it is possible reductions in the number of employees in the office each day will be counterbalanced by the need for lower densities.

The elevated unemployment rate is likely to have a far greater impact on demand in the coming months than new ways of working. Figure 1 shows Experian's forecasts for how far unemployment might rise depending on a base case and a worse case scenario. In the latter, the virus lingers and manages to inflict more structural damage and there are negative impacts from a no-deal Brexit. In the base case unemployment across the UK rises to 6.9% by end 2020 and 8.4% in 2021, only returning to near-2019 levels in 2025.

Figure 2: Vacancy and availability ratio for UK offices

Quarterly data



Source: Cluttons

AVAILABILITY TO INCREASE AS SECOND-HAND SPACE IS RETURNED TO MARKET

New development deliveries and some occupiers looking to offload space meant slightly higher availability of offices in Q2 2020 (Figure 2). Office users prefer to occupy the best they can afford. As requirements for office space reduce, expectations are for a noticeable increase in non-prime space being returned to the market. This will lead to a polarisation between the best and the rest. Rental levels for non-prime offices are likely be negatively impacted as their availability rises. Careful monitoring of availability across office quality as well as locations will be necessary.

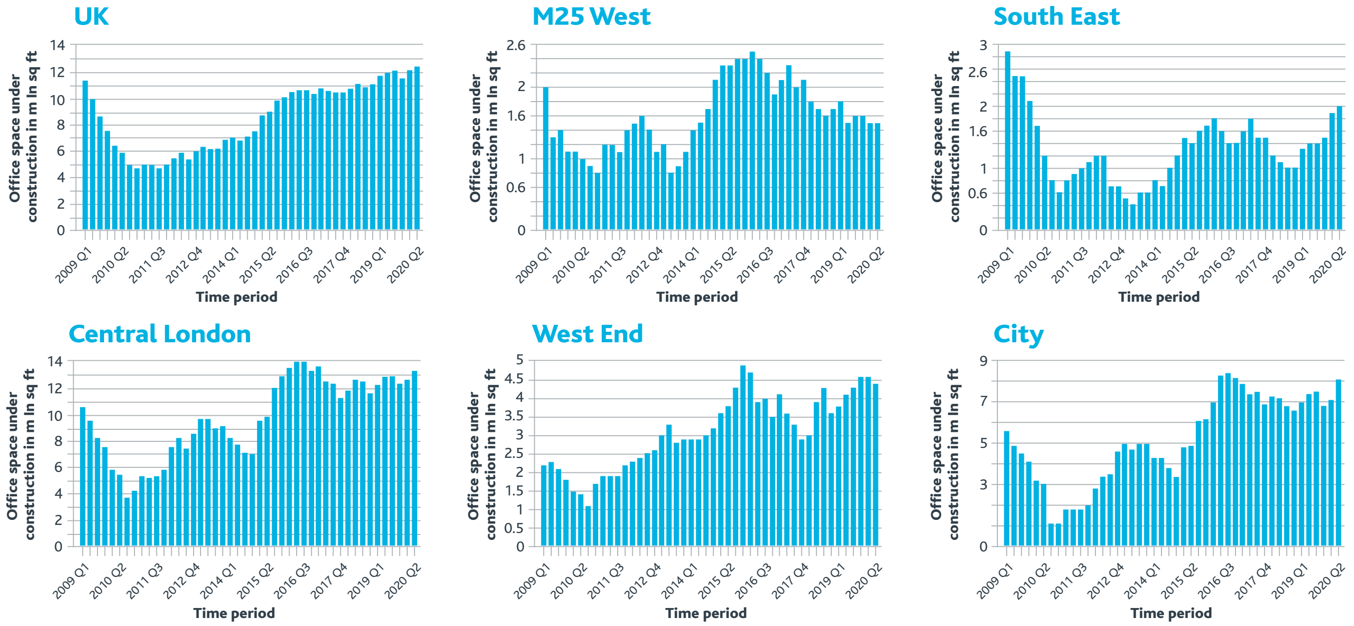
The amount of space under construction has risen across the UK since a low-point in mid-2010 (Figure 4). As is typical the largest office pipeline is in the City of London at 8.1m sq ft against a total office stock off 99.5m sq ft (8.1%). Development activity in the West End is much more restrained at 4.4m sq ft against a total stock of 124.9 m sq ft (3.5%).

Only 1.25% of stock was under construction in the M25 West in Q2 2020. Other areas with subdued construction were Newcastle and Sheffield (although Newcastle is waiting for the latest 107,000 sq ft speculative scheme by Legal & General called The Spark, to complete in January 2022).

Glasgow and Nottingham are on the other side of the spectrum with strong increases in space being developed. There has also been a significant amount of activity in Manchester, with 2.2 m sq ft under construction in Q2 2020. However, Manchester's construction levels peaked in Q3 2019 and are now declining—the level of construction in the city (c.3.4% of existing stock) is now comparable to London's West End.

How much of the UK's development pipeline will be delayed or mothballed remains to be seen. But it is hard to mothball a project once you have started building. For most areas, levels of construction activity are not hugely concerning—but significant levels of second-hand space potentially being returned to market are.

Figure 3: Office space under construction across the UK
Quarterly data



Source: Cluttons | City of London: City core, City Fringe including Clerkenwell | West End: Bloomsbury, Covent Garden, Fulham, Holburn, Knightsbridge, King's Cross & Euston, Marylebone, Noho, Paddington, St James', Victoria, Westminster

WHICH SECTORS AND OFFICE MARKETS WILL SUFFER MOST?

Office markets that are ordinarily densely populated, such as Central London and parts of Greater Manchester, will feel the impact of COVID-19 more sharply as occupancy remains low into the autumn. Reduced demand in the short-to-medium term will come from those sectors impacted by the current crisis, and by Brexit.

Vulnerable occupiers include those associated with retail and manufacturing. Cash flow issues and diminishing profit margins (due to increased costs and disrupted supply lines) will drive unemployment in these sectors. Flexible Offices—where profitability is dependent on high-densities and where short-term contracts are easily cancelled—are also vulnerable. Cities disproportionality reliant on these sectors will be affected.

Under all scenarios except the Single Market, the UK financial sector is expected to lose its 'passporting' rights. This means the financial sector, and businesses making up the ecosystem that support it, are at particular risk. The potential impact on demand for office space in Central London is significant.

The public sector is not invulnerable. With UK Government and Local Authority debt building up budget cuts will need to be made once the current health crisis has subsided. This will lead to as many opportunities as threats over the next decade as the space occupied and owned by (local) government evolves.

> The pandemic has required CRE teams to reconsider their property strategies. This has brought into question the existing purpose, utilisation and location of assets and the role that offices will play in the future. For Local Authorities and Central Government, part of this is the acceleration of existing strategies to promote regional growth and the consolidation and sharing of assets.
>
> – Mark Sambridge, Head of Corporate Services

What the current crisis has made apparent once again is that business and public sector organisations must constantly evolve in line with political and economic change—those that can do so will be best placed to survive threats from Brexit and COVID-19.

THE OFFICE WILL REMAIN AN ESSENTIAL PART OF WORKING LIFE

The death of the office, like the death of so many other things, has perhaps been prematurely proclaimed. Besides the simple fact that not everyone has a suitable place to work while at home, or might not enjoy 'living at work', people mostly enjoy and benefit from visiting the office at least a few days each week. Whether for meetings, work-life separation, some peace and quiet, the use of printer-scanners, training or otherwise.

Why in the long run will a physical office remain attractive to employers and employees alike?

- Employees are a company's most valuable asset and cost much more than the space they occupy in the office. Increases in productivity, staff enjoyment, idea generation and creativity result from face-to-face collaboration. That chance conversation with a colleague while making a cup of tea is hard to replicate online
- Pre-Coronavirus, the average worker was at their desk only 40% of their working day, and generally 80% of office work was defined as "collaborative". Office workers using collaboration extensively require more physical office presence than others
- Total office space costs have fallen as a proportion of total company costs (to 15%). Salaries make up 55% of total company costs, and business costs make up the remainder (according to the British Council for Offices[6]). While businesses might consider the option of reducing their real estate footprint and costs, the impact on the bottom line is likely to be marginal
- The office helps morale, creates a sense of group spirit within the company, aids ingraining a company culture and corporate governance. For the younger generation and new starters, it allows staff to be mentored and trained.

These benefits have previously driven occupier demand towards well-located flexible, efficient, attractive space, which offers amenities, sustainability and wellbeing, a productive environment, and fit-for-purpose technology infrastructure. All of which are vital to the attraction and retention of staff.

With fewer staff returning to the office daily some businesses may seek smaller but higher specification spaces than before. As we emerge from the crisis we are likely to see a polarisation between the best and the rest: the best, most efficient and well-located offices will see the most demand, while mid-quality office space could face significant falls in market rents.

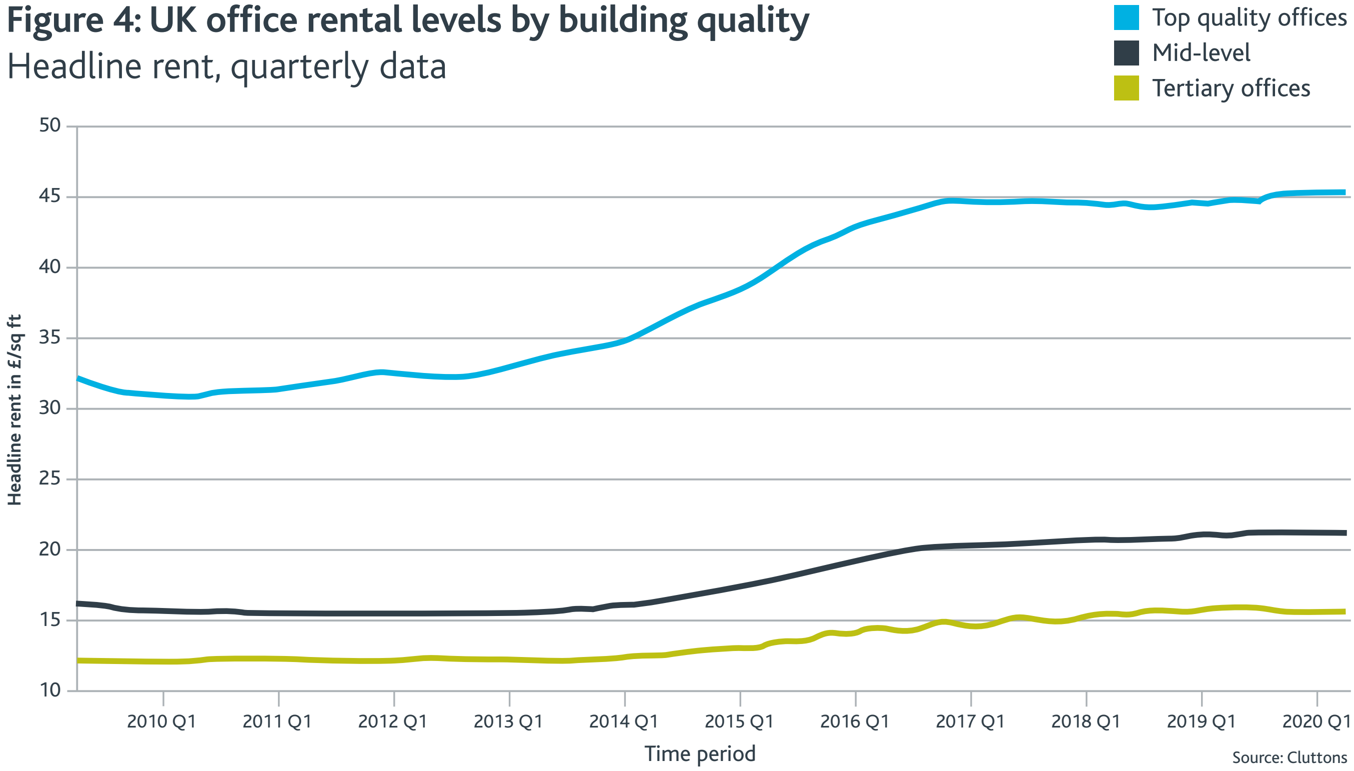
Insolvency negotiations and a search for lower rents and charges will increase in the face of economic strain. Disputes are expected to arise centred around underletting, typically required to take place at a market rent. What constitutes a market rent post COVID-19 is currently unclear. The current climate of uncertainty has pushed landlords to take a more flexible approach to accepting shorter terms and more frequent breaks. There has been an increase in enquiries for ready-fitted Category A+ space, as occupiers aim to preserve capital.

> In addition to greater lease flexibility we have seen a material increase in enquiries for ready fitted space as occupiers seek to preserve capital, which we expect will accelerate the idea of landlords delivering offices to 'Category A+' – a market currently in its infancy.
>
> – Henry Brewster, Office Agency

Figure 4 shows the divide between the best and the rest in office space across the UK, with a rental premium for the most flexible, best quality offices. Rents for mid-quality offices are close to those for the least desirable offices and have benefitted little from rent increases. We will monitor future developments in rental levels by building quality closely.

Figure 4: UK office rental levels by building quality

Headline rent, quarterly data



Source: Cluttons

OUTLOOK FOR RENTAL GROWTH

Property rental income and rental values over the next two years are normally the easiest to project with a reasonable level of accuracy according to analysis of past forecasts. In this current market, with so many unknowns, even forecasting rental values for prime office stock has become difficult.

The temptation is to compare to the big swings in prime office rental value growth during the Global Financial Crisis (GFC). The sharpness of the correction in prime rental values is likely to be much less severe due to the absence of deep structural issues as experienced then. At present, we expect a 5% decline in UK office rental values in 2020, with similar declines in 2021. If social distancing continues to be required throughout 2021, and no trade deal is reached between the UK and EU by the end of this year, declines will continue into 2022.

There will be variances regionally, depending on a range of factors including supply-demand dynamics, local occupier profiles, and the exposure of the latter to Brexit and COVID-19 related risks. Areas like M25 West will suffer less due to the nature of the business located there as well as having a small development pipeline. The markets more at risk of jobs cuts, companies cutting space and the amount of space under construction are the Docklands and the City of London.

FOOTNOTES

1. The South East includes Berkshire, Buckinghamshire, East Sussex, Hampshire, the Isle of Wight, Kent, Oxfordshire, Surrey and West Sussex, including towns like Oxford, Reading and Brighton.
3. West End: Bloomsbury, Covent Garden, Fulham, Hammersmith, Holborn, Knightsbridge, King's Cross/ Euston, Marylebone, Noho, Paddington, Soho, St James', Victoria, Westminster.
4. City of London: City core, City fringe, Clerkenwell.
5. M25 West: Bracknell Forest, Brent, Chiswick, Croydon, Cambridge, Ealing, Gatwick, Guildford central & fringe, Hammersmith North, Hillingdon-Uxbridge, Hounslow West-Heathrow, Maidenhead, Oxford, Reading central & fringe, Richmond, Runnymede-Staines, Rushmoor-Blackwater Valley, Slough, Spelthorne-Staines, Watford central & fringe, Woking.
6. Ramidus Consulting Limited (2016) The Proportion of Underlying Business Costs Accounted for by Real Estate: An Update (p.18) British Council for Office, London.

CLUTTONS

For more information contact:

SOPHY MOFFAT
Head of research
+44 (0) 7970 539 958
sophy.moffat@cluttons.com

STEVEN COOPER
Head of development and planning
+44 (0) 7968 477 895
steven.cooper@cluttons.com

JAMIE MCCOMBE
Head of investment management
+44 (0) 7958 207 027
jamie.mccombe@cluttons.com

ANDREW MITCHELL
Investment agency
+44 (0) 7901 518 749
andrew.mitchell@cluttons.com

MATTHEW PEAKE
Head of commercial and strategic asset management
+44 (0) 7717 558 773
matthew.peake@cluttons.com

RALPH PEARSON
Head of commercial agency
+44 (0) 7894 608 020
ralph.pearson@cluttons.com

JONATHAN RHODES
National head of valuation
+44 (0) 7971 809 798
jonathan.rhodes@cluttons.com

Cluttons LLP

2 Portman Street
Portman House
London W1H 6DU

020 7408 1010
cluttons.com

RICS