

**RIISING TO THE CHALLENGES
OF THE
CENTRAL LONDON OFFICE MARKET**

SURVEY UPDATE

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1. EXECUTIVE SUMMARY

What a difference a year makes! Last year, we reported on supply and demand in the principal London office markets and the implications for business (report attached).

A year on and the picture has changed dramatically.

This paper is an update on what is really happening in the Central London office market and ideally should be read in conjunction with our main report of 12 months ago.

We have also summarised six things that occupiers are doing to stay on top. There are numerous other property related initiatives that can be taken to reduce your costs which we will be raising in future papers.

The implied message in this report update should be clear. As an occupier if you have a lease expiry, a break clause, a rent review or want to dispose of surplus space, the property market conditions are more complicated than ever. Furthermore, and sadly for many readers, the revenue side will not cover up any shortfalls on the cost side of your P&L.

The good news is that there is some light at the end of the tunnel but it is only likely to shine on those who prepare and prepare excellently. If you do leverage your situation really well as some have done, then the chances are that your business will come out the other side that much healthier. In the meantime it is vital that occupiers think about making immediate and sustainable reductions in the property burden. The key word here is sustainable as some deals that are available may actually hide some unpleasant property traps in the future.

2. PROPERTY REPORT UPDATE

2.1 Demand

Activity in the Central London office market has been running at a very low level. The City of London office market may have been written off by many commentators due to its strong association with the financial services sector but whilst demand is at an all time low there is still a modicum of leasing activity as can be seen in the table below.

By contrast, the West End tends to be more resilient to economic trends as it is not so exposed to either a dominant series of occupiers in one sector such as the banks or any one sector such as financial services. The West End is more diverse and as such it tends to be more resilient.

Demand for space had been reasonably consistent over time but letting agents are now all reporting extremely low levels of activity. This is primarily due to the ripple effect we are experiencing which is now affecting the media and fashion related companies.

Over the last quarter of 2008 the West End market has had what many consider to be a “heart attack” with the, take up of space virtually halved - falling to 630,000 sq ft – the lowest level of take up on record.

Offices Take up / Demand

Market	Q4'08	Q4 '07	Change
West End	630,000	1,035,000	-39%
City of London	695,000	1,085,000	-36%
Docklands (Canary Wharf)	550,000	86,000	-15.8%

2.2 Supply

Vacancy levels moved up a full percentage point from 5.7% to 6.7%. This means an extra 900,000 sq ft has come onto the West End market in the last nine months. This supply is mainly from occupiers seeking to reduce their overheads.

Behind the “official” statistics, there is additional space which is not being formally marketed, but could be available. This is called the “Grey” market.

This Grey market develops for three main reasons. First, the occupier thinks it may need the space later; second the lease may not allow the occupier to create a sub-lettable part and lastly the occupier doesn't think it can let it anyway.

There is always an element of slack in normal market conditions but in time of recession or downturn the amount of “Grey” space is a worrying statistic. As economic activity picks up, Grey Market space will be withdrawn from the market, but it will act as a drag on any property market recovery and of course it will represent a cost drain for the occupiers.

2.3 Office Rents and the Implication of Supply and Demand

The Central London offices markets are collectively in a high state of flux. No-one quite knows where or when the bottom will be reached and, in a world where the competition for a tenant is now fiercer than ever, the deals have become far more complex and less open to interpretation.

On the rent side of the equation, the table below highlights the changes that have taken place for Grade A space:-

Grade A Office Rents

Market	Q4'08	Q4 '07	Change
West End	£95.00	£110.00	-13.6%
City of London	£55.00	£63.50	-13.4%
Docklands (Canary Wharf)	£40.00	£47.50	-15.8%

The increased supply and lack of demand has had a clear impact on rents. These are the known headline rents and as such Haywards' feel for the market is that rents have fallen much more and this is irrespective of the inducements being offered.

For Grade B space, categorised as offices that are either centrally heated or over 10 years old, the picture is much worse. It is very typical in recessionary markets for the gap between Grade A and B space to widen.

Grade B Office Rents

Market	Q4'08	Q4 '07	Change
West End	£35.00	£50.00	-30.0%
City of London	£32.50	£40.00	-18.8%
Docklands (Canary Wharf)	£22.50	£25.00	-10.0%

The fall in the West End has been a result of many Grade B buildings being re-priced downwards as landlords have taken the view that it is better to have a tenant rather than stick out for an unrealistic level of rent (when measured against historic market norms).

3. INDUCEMENTS AND OTHER GIVE AWAYS

Beware of those bearing gifts! Irrespective of the falls in headline rents, there is no doubt that letting incentives have increased. Rent free periods are now one month for each year of the lease and, in some cases, much higher although much depends on the rest of the leasing package.

In addition, there are other concessions being made. These might seem attractive on the face of it but could bite back later. Caps and collars, indexation, quid pro quo payment structures and even the payment of professional fees are all items now on the agenda.

4. RATES AND SERVICE CHARGES

There are two other cost areas which will affect operating profits. These are the impending rates revaluation and service charges.

The pricing effects of both of these elements are similar in that we expect them to rise.

Rates are likely to rise as they will be based on April 2008 rent values and at that time rents were high.

Service charges will come under pressure as landlords will want to ensure their properties are kept in top notch condition and being cynical why should they pay for costs if they can legitimately recover costs from the service charge? We forecasted service charges would rise by between 2% and 4% per annum. We still consider this a good estimate.

5. ACTIONS - OTHER OCCUPIERS HAVE BEEN TAKING

A year ago most occupiers were predicting a tightening of the P&L. Generally, revenues were basically looking sound although signs of tougher competition were beginning to creep into the markets. This brought real pressure on labour costs and the premises burden -the two highest costs for most organisations.

In reaction to higher costs pressures, occupiers were changing their behaviours in a number of ways. 12 months on, whilst some of the dynamics like a shortage of decent space have changed, the rules on how to manage costs and to get the best deal have not. Recent research we have carried out with our own Adviser Group shows that most people do not see reducing property costs as a top priority – in fact it ranked number five out of seven options. This may be because occupiers feel that they have limited ability to change the property cost burden. With careful planning the reverse is true..

Here are **6 pointers** to think about:-

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- 1. Mobility – more and more occupiers have been prepared to look outside of their “traditional” locations in search of more affordable space. Although rents have dropped, the search for good deals should continue. A note of caution. Think twice before taking space in areas which the property industry considers unfashionable or highly secondary.**
 - 2. Deal Complexity - the “construction” of deals has become more complicated. If there was a time when rent was the sole issue, this is now long gone. There is a lot more to consider. This provides both opportunities and threats.**
 - 3. Knowledge – leasing turnover (letting activity), has reduced dramatically. Along with this comes a lack of knowledge which in turn affects the exact ‘pitch’ of the market. Only experts will really know where the market, and therefore rents and rent frees are set.**
 - 4. Time – to get the best deal you need lots more time than you may think. Just negotiating a really favourable lease can easily take four months. Then, if you want to get the best deal on your fit out, you’ll need to tender it. This can save you significant sums, BUT to do this well you need to allow enough time.**
 - 5. Headline Rents – beware the cheap rent. Freeholders are blocking deals which don’t meet their requirements. Be cautious of hearsay, it may not be the full story. Incentives can be complicated and often exaggerated.**
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- 6. Covenant Status – landlords are making a big push to safeguard their investments. This means that as an occupier you MUST do everything possible to trade profitably. Landlords will be looking for deposits on leases as well as making sure occupiers adhere to all the clauses of their leases.**
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Clearly there are many other initiatives that can be taken to deal with the property burden. In changing markets the emphasis shifts. For example, occupiers can expect bigger discounting on their property dealings if they are considered a good covenant.

6. CONCLUSION

Although rents have fallen and represent a wonderful opportunity for many companies who have an angle to exploit, the critical question is whether you will be able to sustain any benefit that you secure now. The attraction of a cost reduction today could limit your flexibility tomorrow – at exactly the time when you want to capitalise on the upturn when it comes. As a result many occupiers run the risk of being locked into lease structures which are too rigid for their current needs and certainly more expensive than they can afford.

Our advice here is to consider all the elements of the property burden and choose the solution that provides the right mix of flexibility, cash release, cost reduction, market presence and people productivity.

A final thought

At a time when many of us are reflecting on our actions over the past few years with what the future may now hold, perhaps Charles Darwin might provide a clue for the way we might think about future business property strategies.

“It is not the strongest of the species that survive, or the most intelligent, but the most responsive to change.”

Good property decisions can promote change. They can certainly augment change. Of course the converse can so easily apply. What seems like a great deal today could provide barriers to change in the future. Now is an ideal to make sure your property fits your business – today **and** tomorrow.

For further information on any aspect of this report or on any of our cost realignment and cash release programmes, please do not hesitate to contact any of our Partners.

Haywards is an independent advisor specialising in representing the interests of occupiers...

We deliver and sustain business profitability and flexibility by increasing the contribution made by property and workplace environments.

7. APPENDIX 1 – SERVICE INDEX

Property

Real Estate Acquisitions | Asset Management | Disposals | Due Diligence | Lease Re-gearing | Lease Renewals | Legal Briefing | Planned Maintenance | Rating | Relocations | Rent Reviews | Service Charge Audits |

Capital Projects CDM & Health & Safety Services | Contractor Management | Cost Estimation | Cost Management | Final Account | Procurement | Programming | Project Management | Specification Development | Tender Analysis | Site Management

Workspace Planning & Design Accommodation Planning | Ergonomics | Feasibility | Furniture Selection | Interior Design | Move Management | Space Planning | Workspace Audits

Building Consultancy Building Surveys | Client Representative Service (CRS) | Dilapidations and Reinstatement | Energy Audits | Energy Performance Certificates (EPC) | Lifecycle Costing | Measured Surveys | Mechanical and Electrical Services | Planned Maintenance Programmes | Schedules of Condition

Property & Facilities Management Business Continuity | Co-management of 3rd Party Suppliers | Compliance | Contractor Management | Health and Safety | Migration of Existing FM Operations | Outsource Management | Process Mapping | Procurement Management | Savings Programmes | Settlement Services | Skills Evaluation

Business

Business Intelligence Analysis | Benchmarking | Budgeting | Business Support | Database Development | Due Diligence | Feasibility | Implementation Road-Mapping | Key Performance Mapping | Pre-Acquisition | Research | Strategic/Scenario Planning | Strategies for Property & Space

Transaction Management Change Management | Cost Control | Project Management | Project Planning | Programming | Risk Management | Team Selection & Appointment

People

Workplace Strategies Alternative Work Solutions | Design / Ergonomics | Flexible Working | Post Occupancy Review | Process Engineering | Satisfaction Surveys | Space Utilisation | Workplace Audits | Work-Style Solutions