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Markets in Focus

Time window for investments in London office market in 2024

London's office market faces great challenges but also offers opportunities. The weak economy, financial sector company relocations and the trend towards remote working are all putting a strain on the market. Despite this, the demand for space is currently growing faster than expected and rents are going up. And the strong increase in yield leads to attractive opportunities on the investment market at present. The Real I.S. Research team have been analysing the London market very closely for several months and have made some interesting findings during the most recent market tour.

High take-up of space in rental markets

The office market in London is undergoing change. Buildings are being adapted to tenants' changing requirements at a rapid pace. Some tenants are also relocating, particularly from the Docklands, with some major companies abandoning the east London financial district to move back to the City. One striking example is the recently announced relocation of HSBC. After more than twenty years at Canary Wharf, the bank plans to move its headquarters to the City of London. Optimum public transport links and proximity to cafés, bars and restaurants are important factors in the decision to relocate. Although moving from the Docklands to the City generally involves a reduction in space and higher rents, the strategic plan of the companies making the move is to make their locations more attractive for their employees and improve office attendance. Many companies in the City of London have already called staff back to the office five days a week, and employees are also returning to the office voluntarily to increase their visibility in the difficult job market.

The buildings viewed on the market tour of the City and the West End all offered high-quality amenities, beginning with extensive end-of-trip facilities such as cycle parking facilities, lockers, changing rooms and showers in the basement for employees who cycle to work. This is an accelerating trend. For new office buildings or alterations, the local planning authority will now generally only grant planning permission for very few, if any, underground car parking spaces in order to alleviate the traffic problem in the centre of London. As a consequence, in addition to public transport, the bicycle is a popular alternative to the car as a way of getting to work. Contemporary modifications were also to be found on the ground floors of the buildings viewed. In the open space next to the entrance there is now often a cafeteria, which provides a convenient place for staff members to have breakfast and also a casual meeting place for employees and visitors. On the top floor, a roof terrace for internal and external events has now become a must-have for modern office spaces. Much attention is now also being given to the environmental, social and governance (ESG) standards of buildings, and tenants are generally looking for properties with an energy efficiency rating of 'A' or 'B' to rent. However, buildings with a weaker energy rating can usually be upgraded to achieve a higher rating for relatively little cost.

The demand for superior office spaces that meet these standards has grown noticeably. As in continental European cities, the quality gap between modern and unmodernised spaces on the London office market is growing, and this is reflected in the take-up of space, the vacancy rate and the rents.

For instance, prime rents in the City of London and the submarket of the West End/Midtown have risen by 15% and 24% respectively since the end of 2019, far faster than the average rents in the centre of London.

Investment markets offer opportunities

London's office property market is still bearish. Asian buyers are the only ones active on a large scale in the market. However, up to now there have been few sellers in the market prepared to sell existing buildings at the considerably lower price level.

There are a number of reasons to expect greater market activity in 2024. A record volume of GBP 6.3 billion in office real estate loans is due for follow-up financing in the current year. However, capital market interest rates, the basis for the calculation of loan interest rates, have seen a steep rise in the past few years.

Property values have also fallen due to the market correction. Unlike in Germany, surveyors in the United Kingdom value properties at their market value. If the same amount of debt is refinanced for an office building, the lower property value results in a higher loan to value (LTV) and thus – in the current market environment – a higher bank margin, on top of the increased cost of funds. Overall, the follow-up financing costs for a five-year fixed-interest loan can be around 400 basis points higher than at the end of 2019. Properties that no longer deliver sufficient yields, given the high interest costs, could then come onto the market in fire sales.

However, the attractive property yields also indicate greater market activity. Prime office properties are currently being offered at starting yields of 5-6% in the City and 4-5% in the submarket of the West End/Midtown. These are the highest yields since 2010, so many investors see opportunities to enter the London office market in the coming months.

Conclusion: London offers comparatively resilient occupier markets for office real estate in the top segment and also high initial yields, in historical terms, in the investment market. This great global city on the Thames is therefore definitely back on the list of target markets for investors.

Kind regards

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