RESEARCH

THE LONDON OFFICE MARKET Q2 2020

THE COVID-19 PANDEMIC

CGI: 22 Bishopsgate, EC2

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Carter Jonas

When businesses emerge from lockdown many will seek ways to reduce their operating costs to maintain profit margins in a post-COVID-19 world, when revenue generation is likely to be appreciably more challenging.

Real estate often represents the second largest operating cost of most businesses, after staff salaries. In the coming months businesses are therefore likely to be implementing policies to downsize headcount and reduce their exposure to real estate costs.

Vacancy in the second-hand office market is likely to increase as businesses offload surplus space to sub-let and introduce more efficient ways of utilising the real estate that is to be retained – with a greater emphasis on agile / home working.

Before the onset of the pandemic, the key feature of the London office market was the lack of well located, available, good quality space to meet demand. Occupiers were prepared to pay record rents to secure the best space, which was increasingly being used as an integral part of corporate recruitment strategies to attract and retain the brightest and the best. However, the priorities of many businesses are now likely to have shifted away from recruitment and towards the safety and wellbeing of their current workforce.

“THE IMMEDIATE CHALLENGE FOR OFFICE OCCUPIERS IS TO FORMULATE OPERATING AND EMPLOYEE WELLNESS POLICIES THAT ARE COMPATIBLE WITH REDUCING REAL ESTATE COSTS TO MAINTAIN PROFITABILITY”

Forecast market trends - the key points

We set out below the key trends that are likely to emerge over the coming months as the London office market responds to a more challenging, post Coronavirus, economic environment:

- lower rents
- longer rent free periods
- rising vacancy levels
- more choice
- a stronger bargaining position for tenants
- shorter leases and more frequent break options

Rising vacancy

Over the coming months it is very likely that office vacancy will rise, especially in the second-hand market, due to a combination of factors:

- the completion of new office developments that are currently under construction
- some businesses ceasing trading
- retrenchment in the serviced office sector due to overcapacity
- overseas businesses repatriating some of their operations – news agency Buzzfeed is a recent example
- occupiers offloading surplus space by sub-letting, in tandem with:
  - reducing headcount
  - adopting an operating model that is more biased towards agile working – Facebook has recently announced that it will be moving towards a permanent policy of remote working

Footloose tenants will therefore have the benefit of more choice and a better bargaining position in lease negotiations.

Weaker demand

The economic shock that has been precipitated by the COVID-19 pandemic will weaken demand for London office space as occupiers put expensive, capital intensive, investment decisions, including office relocations, on hold until economic stability is restored.

Although there has been some market activity during the lockdown period, including US law firm Covington and Burling taking 86,000 sq ft at 22 Bishopsgate, EC2 and the pre-letting of 40,000 sq ft at 1 Newman Street, W1 to investment manager, Exane, the net position is one of weaker demand.

Several large scale lettings in the City of London have reportedly been shelved including, for example, the proposed leasing of circa 120,000 sq ft at 80 Fenchurch Street, EC3 to US technology company, Salesforce and the leasing of circa 59,000 sq ft at 60 London Wall, EC2 to investment manager, Alliance Bernstein. Amazon is also understood to have put its circa 200,000 sq ft City office search on hold.

Shorter leases

Those tenants that are seeking to relocate, perhaps to downsize, or move to better quality space by taking advantage of lower rents, are likely to demand shorter leases or more frequent break options to hedge against the risk of future economic shocks.

Lower rents & extended rent free periods

The combination of rising vacancy and weaker demand will conspire to put downward pressure on rents across London in both the new space and second-hand markets.

In tandem with declining rents it is very likely that rent free periods will expand as landlords compete to secure lettings with fewer footloose tenants by offering more generous incentives.

Once the COVID-19 lockdown has been fully lifted, the number of leasing transactions in the London office market should begin to rise to the extent that new rent and rent free period benchmark trends will begin to emerge.

Better value for money

Prior to the COVID-19 pandemic, the London office market was characterised by historically low vacancy in the new Grade A office sector, rising rents and increased pre-letting activity as tenants competed to secure the best available floor space to underpin recruitment, retention, productivity and wellness strategies.

Pre-Coronavirus, many tenants were being priced out of their preferred areas of search in a rising market. With the inevitable re-alignment of rents and rent free periods that will characterise the London office market over the coming months, office space that, hitherto, may have been considered too expensive is likely to be priced at a level that offers significantly better value for money.

Lease renewals & rent reviews

The mechanism for setting the rent on a lease renewal or rent review is typically predicated on assessing the rent and rent free period letting packages that are being agreed on office space of comparable size, location, quality and specification.

Over the coming months, open market lettings are likely to create new, lower, rent benchmarks that will underscore the case for a reduced rent when negotiating a lease renewal or a rent review that is linked to a break option.

Social distancing in the workplace

The Government's guidelines on 'social distancing' in the workplace will require employers to reduce their office occupancy densities which, pre-pandemic, typically averaged 90 – 110 sq ft per person, including an allowance for ancillary accommodation such as meeting rooms, reception and kitchen space.

A reduction in occupancy density could be achieved by adopting several strategies including:

- changing seating and desk layouts
- using meeting rooms for day-to-day office functions
- requiring staff to work at home and only visit the office on specific days to collaborate on key projects
- adopting a shift system for those employees who need to be in the office in order to fulfil their job functions - so that headcount is kept below a pre-defined level

Employers will need to take all steps necessary to reassure employees that it is safe to return to their usual place of work and a careful balance will be required between personal safety, team productivity and maintaining a vibrant, attractive, working environment that will keep staff motivated.

Social distancing in the workplace will therefore have a profound effect on the way that real estate is occupied and how businesses operate.

"DESPITE WORKING FROM HOME CURRENTLY BEING THE 'NEW NORMAL', THE BEATING HEART OF MOST BUSINESSES WILL, POST COVID-19, CONTINUE TO BE THE OFFICE WHICH PLAYS HOST TO TEAM COLLABORATION, INNOVATION AND STAFF AND CLIENT INTERACTION"

Serviced offices

The serviced and co-working office sector has expanded rapidly in London over the last few years and in the months leading up to the COVID-19 pandemic a period of consolidation in the sector was already underway to address the issue of overcapacity. WeWork's well publicised funding problems was one manifestation of this issue.

The Coronavirus, and the consequent need for social distancing in the workplace, will hasten consolidation in the serviced office sector which is predicated on a high-density headcount business model in order to secure commercially viable returns.

The need for employers to adopt a lower office occupancy operating model is likely to lead to structural change within the serviced office sector. Some operators may cease trading – leading to increased office vacancy - unless they are able to restructure their operating costs by negotiating lower rents with their landlords.

Travelling to work

If the challenge of creating a safe working environment is not sufficient to preoccupy employers, there is also the key issue of getting the workforce to the office. How are employees to be reassured that using public transport will not be detrimental to their wellbeing? Phased shifts that are compatible with travelling outside peak commuting times might be one answer and for those who live in London there is always the option of cycling or running in to work.

The future

Will the COVID-19 pandemic bring about structural change in the demand for office space? Quite probably. Employers that were previously resistant may now be more inclined to adopt agile / home working operating policies permanently to reduce their property footprint, and exposure to real estate costs, in what is likely to be a harsh economic environment for the foreseeable future.

Employees may press for the adoption of a permanent policy of agile working, enabling them to work from home on specified days of the week. This accommodation strategy is likely to be of particular interest to long distance commuters, resulting in reduced travel costs and a better quality of life - employers are also likely to benefit from a healthier, happier and more productive workforce.

However, while we may witness, over the next few years, a contraction in the quantum of office space leased by office occupiers when benchmarked against headcount, it is unlikely that the office, as a focal point for staff to meet, collaborate and socialise will disappear altogether. Even before the COVID-19 pandemic, several academic research projects demonstrated that prolonged agile / home working did not suit certain groups of workers, some of whom felt socially isolated while others were concerned that they would be overlooked for promotion because they were no longer visible to their line manager.

THE TENANT REPRESENTATION TEAM

Carter Jonas' tenant representation services include:

- Stay put/relocate cost appraisals
- Office search & relocation management
- Relocation budgeting & planning
- Lease & rent review negotiation
- Repairs/dilapidations cost assessment & negotiation
- Building, air conditioning & passenger lift surveys
- Business rates analysis & appeal
- Service charge audit

For more data on the London office market, office availability, rents and rent free periods, market trends and information on budgeting and planning for a lease renewal, rent review or office relocation please contact one of the team.

OUR EXPERIENCE

Lease negotiations and relocations 10,000 sq ft+

43,000 sq ft
UK Payments Administration
2 Thomas More Square, E1

39,000 sq ft
Care Quality Commission
151 Buckingham Palace Road, SW1

28,000 sq ft
Warner Bros/Shed Media
85 Grays Inn Road, WC1

27,000 sq ft
Reinsurance Group of America
22 Bishopsgate, EC2

17,500 sq ft
Hackett Limited
The Clove Building, SE1

16,000 sq ft
Circle Housing
Two Pancras Square, N1

15,000 sq ft
Hitachi Rail Europe
40 Holborn Viaduct, EC1

11,000 sq ft
Salamanca Group
50 Berkeley Street, W1

33 OFFICES ACROSS THE COUNTRY, INCLUDING 9 IN CENTRAL LONDON

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ABOUT CARTER JONAS

Carter Jonas LLP is a leading UK property consultancy working across commercial property, residential sales and lettings, rural, planning, development and national infrastructure. Supported by a national network of 33 offices and 800 property professionals, our commercial team is renowned for their quality of service, expertise and the **simply better advice** they offer their clients.

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