Real Estate Research

March 2025

A Tale of Two Cities: London's Office Divide

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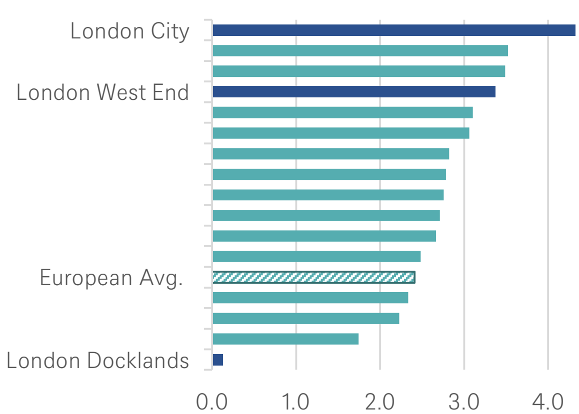
IN A NUTSHELL

- Location matters more than ever: Occupiers are gravitating towards well-connected submarkets with strong amenities, reinforcing the critical role of location.
- While asset quality remains key, submarket selection is paramount. Well-located assets, even if not considered 'best-in-class' should continue to thrive. In weaker location, however, even Grade A offices face challenges.
- In prime areas, active asset management may help enhance long-term performance and targeted improvements can unlock significant value. Owners of poorly located assets may need to consider alternative uses or an exit strategy.

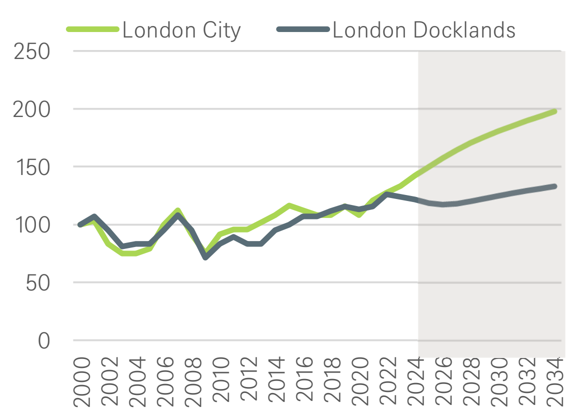
London Office Market: A leader or lagger?

The answer is both... dependent on where you're looking. In our latest house view, DWS identified the London City submarket as the European office market expected to enjoy the strongest prime rent growth over the coming five years. Whilst this may appear upbeat for the UK capital, towards the very bottom of the pack sits London's Docklands submarket.

European Prime Office Rent Growth Forecast
2025-2029F % pa



London Prime Office Rent Growth Index
2000 = 100



Sources: DWS, European Real Estate House View forecasts and Property Market Analysis, December 2024

Our latest rent growth forecasts highlight the widening divergence in performance that we expect to see across London's office stock over the coming years. Whilst we only forecast the three main London markets of West End, City and Docklands, a deeper dive on London's individual submarkets would likely show an even starker divergence.

Location, Location, Location

Competing with the 'home office', in order to entice staff back to the office, the post-Covid environment has seen companies prioritise central locations, well-connected to public transport links and rich in amenities and after-work entertainment. This trend has undoubtedly strengthened the traditional 'core' markets.

London's City submarket is one such example and Property Market Analysis even went so far as to label the City occupier market as a 'Boomtown'. It's true that the demand dynamics have been remarkably strong in recent years, with office take up in 2024 running nearly 20% higher than pre-Covid averages. In addition, pre-letting is at an all-time high.[2] As such, prime rents in the City core saw an increase of nearly 7% over 2024, to reach £85.40 psf (pound per square feet). Exceptional rents, exceeding over £100 psf, are becoming increasingly common in best-in-class stock and we anticipate this trend to persist, with such rents likely to be standard in prime buildings by 2028.[1]

The City has benefitted to the detriment of Docklands (Canary Wharf). A number of high-profile occupiers, including HSBC and Clifford Chance, are relocating to the City, while others, such as Morgan Stanley and Barclays, are downsizing their office footprints. As a result, the Docklands is grappling with a vacancy rate of over 16% and rents have been trending down. Although there are plans to rejuvenate the area through a mixed-use development strategy, removing office stock in the process, we expect further challenges for the Docklands over the coming five years, with continued underperformance likely.

In the West End, rent growth has averaged 8% per annum over the last four years, driven by strong demand for limited Grade A space. Mayfair and St James, long valued for their prestigious postcodes, continue to attract private equity and hedge fund occupiers, willing to pay top rents despite prime rents now comfortably exceeding £140 psf. In Soho, less than nine months' worth of supply[2] and a subdued development pipeline should ensure prime rents continue their robust upward trajectory. Nearby Fitzrovia has also solidified its position as a highly desirable office location, offering a vibrant mixed-use environment, proximity to world-class retail, and relatively more affordable rents compared to other core West End submarkets.

Beyond the traditional core, newer office submarkets such as Kings Cross and Farringdon have emerged as notable success stories. In particular, these submarkets have benefitted from their appeal to the tech and creative sectors, with high-profile tenants like Google and Facebook taking space in Kings Cross. Prime rents in Farringdon have been bolstered by the enhanced connectivity provided by the Elizabeth Line. Both submarkets stand out for their strong transport links and vibrant mixed-use environments.

In contrast, Aldgate, a newer submarket in East London, has not experienced the same level of success in recent years. Despite more affordable rent levels, the lack of robust infrastructure and amenities has made the area less attractive to office occupiers. Demand has remained low since 2020, and Aldgate is currently struggling with a vacancy rate exceeding 20%. As a result, it is the only Central London submarket where rent levels have yet to surpass their pre-pandemic peak.[2]

Lastly, the outer London office submarkets are also showing divergent trends. In Hammersmith, prime rents have fallen by over 5% since the beginning of 2020[3] driven by a significant drop in office demand post-Covid and the relocation of key occupiers, leaving vacancy rates near 30%.[2] Conversely, White City has seen a 5% increase in prime rents over the same period, bolstered by demand from the life sciences and education sectors given its proximity to Imperial College London.[3]

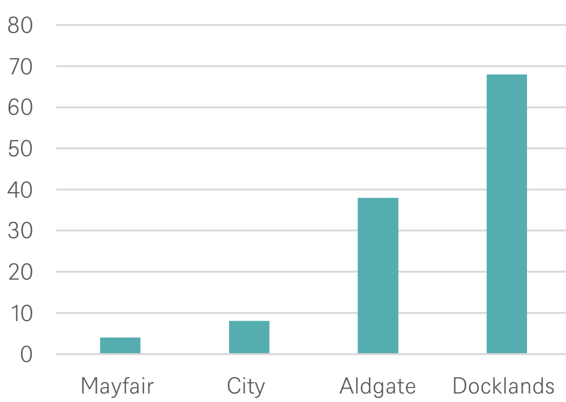
[1] DWS, December 2024
[2] Property Market Analysis, January 2025
[3] Knight Frank, January 2025

Opportunity to Manage-to-Core

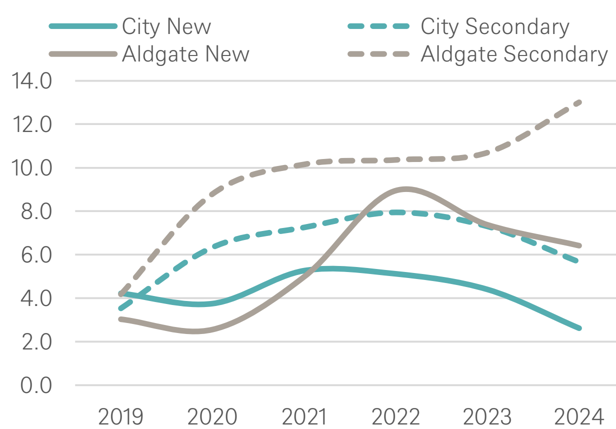
By now we are well versed in the 'flight to quality' trend and it is undeniable that blue-chip businesses are targeting best-in-class space with the highest ESG credentials. According to Savills, over 59% of Central London office take up over 2024 was for space rated BREEAM Excellent or Outstanding.[4] In contrast, lower-quality assets are facing operational challenges, evident in the fact Central London's office vacancy continues to be dominated by secondary stock.

While the importance of quality is undisputed, we believe location could be the key determinant of office performance. In weaker locations, even best-in-class assets are experiencing difficulties. In Docklands, for example, a significant proportion of newly completed office space remains vacant, with availability in 'best-in-class' buildings - completed since 2020 and holding the highest sustainability credentials – sitting close to 70%. In comparison, in the core West End and City submarkets availability in newly completed office stock is between 5% and 10%, reflecting strong pre-letting activity and short void periods for speculative space. Similarly, while Aldgate's vacancy rate remains dominated by secondary stock, new supply accounts for over 6% of total vacancy, compared to under 3% in the City.[5]

Best-in-Class Office Availability
% of availability in newly completed office stock*



Vacancy by Quality
% of total stock



*Based on buildings completed with BREEAM Outstanding/Excellent between 2020 and Q2 2024 inclusive as % of total stock
Source: Property Market Analysis, DWS, January 2025

While 'Trophy' or 'Next Generation' assets are commanding the most attention in the current market, our analysis suggests that occupiers seeking 'best-in-class' office space could find it in cheaper, more peripheral markets such as Docklands or Aldgate. However, many occupiers are choosing instead to prioritise prime, central submarkets, even if it means compromising on quality. This is evident in the fact secondary availability in core West End and City submarkets has been trending down, whereas has continued its upwards trend in the aforementioned submarkets of Aldgate and Docklands. It is perhaps unsurprising, therefore, that London City's 'average' rent growth of 1.4% per annum over the last five years has outperformed Aldgate's prime rent growth of an average of 0% per annum over the same period.[5]

In addition, there are undoubtedly occupiers that wish to be located in prime submarkets but cannot afford the top rents and are looking for high-quality office stock a notch below 'best-in-class'. With that in mind, for owners of offices in prime locations, we see the opportunity to create value through modest capital expenditure. By implementing strategic asset management initiatives, such as upgrading amenity spaces or modernizing Cat A fitouts with energy-efficient features such as LED lighting, owners can substantially enhance the appeal and performance of a well-located but underperforming asset.

[4] Savills, January 2025
[5] Property Market Analysis, January 2025

In weaker submarkets, even ensuring office stock meets sustainability and quality standards may not be sufficient to generate tenant demand and owners of assets in these locations may need to adjust by lowering rents or offering higher incentives. Alternatively, repurposing an obsolete office to its highest-and-best use, such as residential or hotel conversions, could significantly enhance the utility and profitability of the asset. In cases where such conversions are not feasible, the most appropriate strategy may be to consider a sale, as we anticipate continued rental correction and potential value erosion for poorly located, secondary office assets.

Conclusion:

The London office market is expected to continue its polarisation, with location remaining the key driver of performance. Well-located assets, even if not classified as 'best-in-class', should continue to thrive, especially when coupled with active asset management strategies. Indeed, for secondary assets in strong locations, such as the City core and West End submarkets, targeted improvements can unlock significant value. However, for assets in weaker submarkets, such as the City fringe or Hammersmith, repurposing or conversion to living may offer the best path to maximising profitability.

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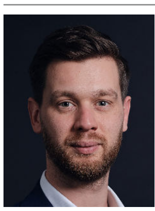
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