Research Briefing

GVA Grimley

Midtown Review

Autumn 2009

Introduction

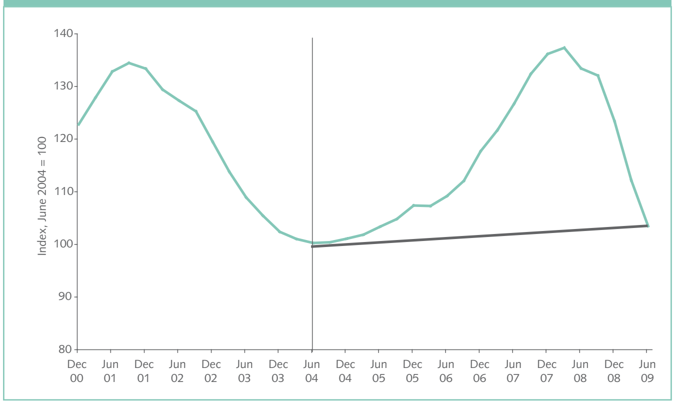
Rental values across the UK commercial property sector peaked a year ago. The central London office market has seen a particularly steep fall in rental values, as is typical with the more cyclical nature of this market. However, within central London there are marked differences at a more local level, with some of the capital's sub-markets seeing a much steeper turnaround in market conditions than others.

This short bulletin focuses on the Midtown sub-market, where conditions have tipped in favour of the occupier to a much smaller degree than is typical across central London as a whole, particularly at the prime end of the market.

What have the trends in rental values been over the last five years?

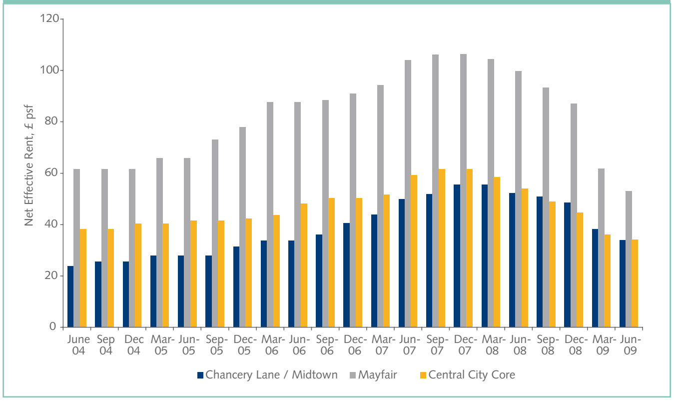
The chart below shows the change in average rental values in Midtown (as an index with June 2004 as 100) using the IPD Quarterly Index. This shows that as at June 2009, average rental values were still slightly higher than five years ago, although only by 3.2%.

Average Rental Index - Midtown Source: IPD, GVA Grimley



However, the story at the prime end of the market is somewhat different. As the chart top right illustrates, net effective prime rents in Midtown (Chancery Lane) have not fallen to the same extent as those in Mayfair or the City Core. Indeed, whilst net effective rents in Mayfair and the City Core are now below those achievable five years ago (by 14% and 11% respectively), net effective prime rents in Chancery Lane are still 43% above their level of five years ago. Indeed, prime net effective rents in Midtown are now at the same level those in the City, as the chart shows.

Net Effective Prime Rents Source: GVA Grimley



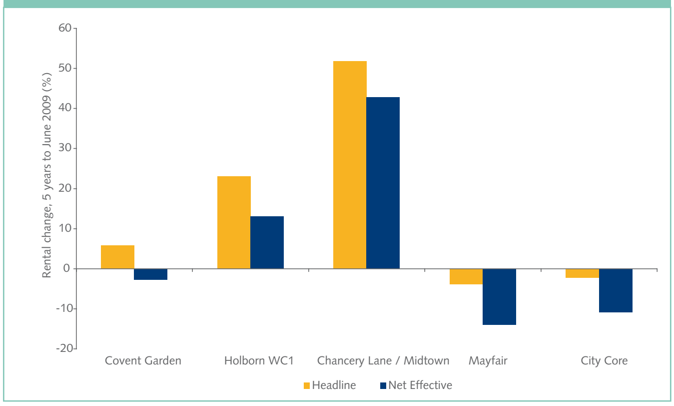
There is significant variation by location, and not all Midtown locations have seen such a steep increase since 2004 – indeed, some are now showing a modest decrease in net effective rents, as the next table and chart show. The clear message is that whilst some leases may see no increase at an upcoming rent review, others may potentially see a substantial increase.

Prime (Grade A) Rental Change

	June 2004		June 2009		
	Prime headline Rent	Net Effective Rent	Prime headline Rent	Net Effective Rent	Change in Net Effective Rent
Covent Garden	£42.50	£39.30	£45.00	£38.25	-2.7%
Holborn WC1	£32.50	£30.10	£40.00	£34.00	+13.1%
Chancery Lane / Midtown	£28.00	£23.80	£42.50	£34.00	+42.9%

Source: GVA Grimley

Prime Rental Change, 5 years to June 2009



Of course, every building and location is unique, and the analysis here can only provide a broad guide. The actual change will depend on a wide variety of factors based on the specific building, its location, and the conditions in the local market.

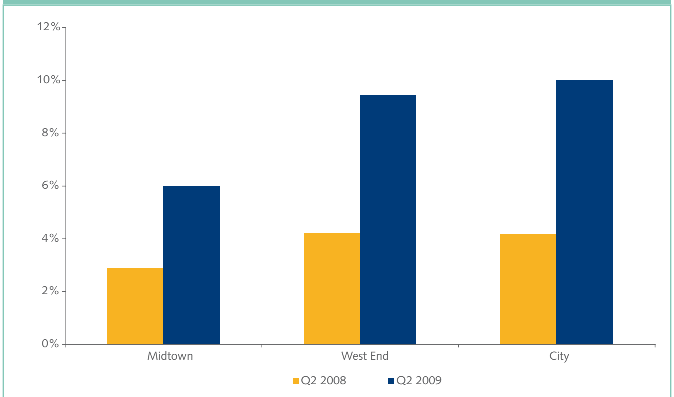
What is the outlook for rental values?

The UK economy is experiencing the deepest recession since the 1930s, and although economic output reached its low point at the end of last year/beginning of this year, growth is likely to resume at only a very gradual pace. Following a forecast fall in output of more than 4% this year, we expect growth to resume next year, although by less than 1%, compared with a long-term trend rate of 2.7% pa.

Problems within the financial services sector present the central London market with a particular headache, although job losses appear to be occurring at a slower rate than expected at the start of the recession. With a considerable lag between output growth and employment, it is likely to be late 2010 or 2011 before the trend of falling employment in central London reverses.

The fall in occupier demand occurred just as a large number of schemes were completing in central London. The impact can be clearly seen in terms of rising vacancy rates, as illustrated in the chart below. As at Q2 2009, vacancy was 9.2% for central London (City, Midtown and West End), compared to just 4% a year previously. However, Midtown has clearly not been as heavily impacted – vacancy stands at a much lower 6% in Q2 2009, having risen from just 2.9% a year ago.

Central London Vacancy Rates Source: GVA Grimley



Although the current development cycle has not been as pronounced as that preceding the early 1990s property crash, there has been a considerable amount of speculative development activity in the central London office market. With almost all new construction activity on hold due to a combination of weak occupier demand and a lack of viability, eventually excess supply will be used up.

Again, Midtown has seen a lower level of development activity than the City and West End. Just under 850,000 sq ft was under construction in Midtown as at Q2 2009, representing only around 8% of the total space under construction in central London, despite Midtown accounting for 16% of the total market size.

Clearly, weak demand and rising supply will have a significant impact on the central London office market and a further fall in rental values is inevitable until the supply/demand imbalance corrects itself. However, Midtown may well continue to see a shallower fall in rental values, particularly towards the prime end of the market, in line with lower vacancy and less new space coming forward.

Indeed, we expect less than 250,000 sq ft to complete next year, and well under 200,000 sq ft to complete in 2011. This is undoubtedly storing up a supply shortage for the future, and is likely lead to upward pressure on rental values ahead of markets such as the City Core, where prime supply is greater.

Key Trends and opportunities

- Midtown offices are more likely to experience an increase in rent at forthcoming rent reviews than in many other areas of central London, particularly for better quality space. However, even within the Midtown sub-market there is considerable variation in the extent to which rents have changed over the last five years.

- Central London vacancy rates are rising, but the rise is not as steep in Midtown as in the City and the West End. Development activity is also lower in comparison with central London as a whole. We therefore expect the Midtown rental market to be more robust than in many other locations.

- Rental values will continue to be under pressure over the next two years and may fall below the rent passing. However, this does not suggest that nothing happens at rent review. Indeed, an over rented property is a problem for both the landlord, as it may adversely affect the capital value, and the tenant, who could well be paying more than the open market rent. However, this could create an opportunity to regear the lease.

- In cases where there is a break clause in the lease, this could present an opportunity for the tenant to surrender the break clause in return for a reduction in rent. This not only benefits the tenant through lower costs, but benefits the landlord by providing a guaranteed income for a longer term and a potential uplift at the next review in five years' time, increasing the attractiveness of the investment. Where there is no break clause, an extension of the lease term in exchange for a lower rent provides an alterative.

- However, we believe that there is no reason to link approaches to specific events such as rent reviews and break clauses. Indeed, the current economic climate provides a major opportunity to look at restructuring leases to the mutual benefit of both landlords and tenants.

Technical note: For the purposes of this bulletin, statistics for central London refer to the West End, Midtown and the City, but exclude Docklands. Statistics for Midtown are for the WC1 and WC2 postcodes. Net effective rent is calculated on the basis of a ten-year lease, adjusted for rent free periods, with a 6-month rent free as standard (and therefore deducted from the calculation).

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Published by GVA Grimley Ltd – 10 Stratton Street, London W1J 8JR

Printed on recycled paper

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