A new lease of life

The changing nature of office occupation in London

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Across the London office market, lease lengths have been reducing consistently over the past two decades. They remained at a record average low of 5.5 years in 2018.

While occupiers are as footloose as ever, disparities in lease lengths, from one submarket to another, persist. Variation between the highest at Canary Wharf (9.3 years) to the lowest, at Aldgate (4.1 years), asks questions about the nature of supply and occupier profile, as much as the growing trend for flexible leasing.

The office market of London has a remarkably diverse occupier base with the various business sectors applying their own set of principles to leasing strategies. This will often dictate the nature of lease events, regardless of geography or building specifics.

Although average lease lengths, for all sizes of occupation, have fallen since the mid-1990s, landlords and developers of larger scale development space continue to require longer term commitments from tenants.

Serviced offices providers have exploded onto the London scene. While saturation remains a possibility, the power of flexibility is now in reach for more occupiers than ever. Landlords are responding and the leasing landscape is being disrupted as never before.
MARKET FORCES CONTINUE TO EXERT PRESSURE ON LEASE LENGTHS

- The last 18 months across the London office market have been dominated by continued political and economic uncertainty. Regardless, 2018 was a strong year in terms of demand and transactional activity, easily surpassing the longer term average and demonstrating uplift in nearly all submarkets.
- While on the face of it that should sit well with landlords and investors, as in other property sectors, structural shifts are at work that are set to permanently alter the tried and tested formulae for occupation and leasing.
- Colliers International has analysed the changing nature of lease terms across the entire London office market since 1996. Deals data has been gathered across all size bands and geographies, in order to ascertain whether the anecdotal indicators of reducing lease lengths and occupier demand for overt flexibility, can be backed up by hard facts.
- Figure 1 clearly shows a reduction in lease lengths across London, over the past 22 years. Average lease lengths have fallen from 21.7 years (1996) to a low of 5.5 years (2017 and 2018). Interestingly, lease lengths remained flat in 2018, the first time this has happened during the entire study period from 1996-2018.
- Average lease length between 1996-2018 is 12.7 years, putting current levels at over 50% below the long-term trend. The age of 25 year leases has long evaporated, except for Flexible offices providers and all but the very largest blue chip occupiers. Currently, six submarkets are experiencing average term certain lease lengths of five years or below (see Figure 2). Nevertheless, the question has to be asked, how short can lease lengths truly become?
- Although the majority of London submarkets are below the current average figure of 5.6 years, Canary Wharf has resisted the sharp falls that other submarkets have experienced. Major relocations to Canary Wharf, involving the movement of thousands of personnel, are not undertaken lightly and will inevitably go hand-in-hand with longer term commitments.
- Indeed, 2000-2002 saw Clifford Chance, Northern Trust, Morgan Stanley, Barclays and HSBC relocate from City of London sites, with a dislocation of up to 20,000 individuals. The average lease length signed by the five occupiers was 24 years, with a combined term certain of 120 years. While lease lengths have reduced, occupier commitments at the Wharf still remain above average. 2018 saw four, term certain, leases signed in excess of 10 years.
- While Canary Wharf remains an outlier, overall average lease lengths in the submarket are still down by 59% since 1994. This compares to the City at 76%, with the West End and Central London at 75%. More significantly, since 2012, Canary lease lengths have actually increased by 11%, partially driven by public sector transactions, while in every other sub-market they have continued to contract, down by 32% across London as a whole.
- Canary Wharf however, is a small contributor to overall lease length data, given the limited number of deals transacted in any single year. There were still 193 leases recorded during 2018 with ‘term certain’ in excess of 10 years. Nevertheless, this only represents 11% of overall leasing activity.
- Figure 3 shows clearly how the leasing landscape has shifted over the past 15 years. In 2005, leases with minimum 10-year term certain, accounted for 88% of all leasing activity. As at the end of 2018, that figure had fallen to 79%. Sub 2-year leases, virtually non-existent, prior to 2015, although still a small proportion of the market, are now here to stay. Leases of five years or below have been in the majority since 2014. As at the end of 2018 they represent 70% of all leases signed in London.
While it is difficult to provide hard evidence that the rise of the serviced office sector is the prime mover for the reduction in lease lengths, it remains an inescapable conclusion that occupiers are seeking much greater flexibility when it comes to real estate commitments. Figure 4 outlines the growth in flexible space in the City Fringe and contrasts it with the sharp decline in average lease terms over the same period. One of the key geographical areas for flexible offices growth over the past few years has been the City Fringe, embracing Aldgate, Clerkenwell, Farringdon and Shoreditch. City Fringe average lease lengths are now some of the shortest across Central London, at 4.6 years, down by close to 80% since 1996. At the same time, the growth of flexible office offering has been unstinting. Leases and sales to flexible offices providers have nearly quadrupled since 2014, with overall City Fringe stock now reaching 1.6 million sq ft. This accounts for approaching 10% of office stock within the City Fringe, compared to London as a whole, where the equivalent figure is just 5%. City Fringe locations; Farringdon, Shoreditch, Clerkenwell and Aldgate, now occupy four of the six shortest lease environments in London. While the four micro locations have not always been in sync when it comes to average lease lengths over the past two decades, as at the end of 2018, they have never been more closely aligned (see Figure 5). Rental profiles vary, but the demand for flexibility from the typical fringe occupier is now common to all peripheral City markets.
Despite the ever evolving footloose nature of occupation in London, the growth of office hubs, commercial communities and urban villages is acting as a magnet for like-minded and compatible occupiers within specific business sector groupings. In many respects, the media and tech sector has been the standard bearer for London’s continued global magnetism. London is still one of the top global financial centres, but it is the increasing diversity, access to funding and skilled personnel, as well as the relatively transparent nature of its property market that are contributing towards its resilience.

In reality, the incidence of media and tech occupation, but specifically the latter, in these geographies, is a key factor in driving down lease lengths. In the City Fringe in 2003, ‘Media’ take-up was relatively modest. By 2010 numbers were rising but still focussed on media style tenants. Between 2010-2012, the landscape was beginning to change as a new wave of ‘Tech’ tenants drove eastwards.

From 2015 onwards, with the bar of lease flexibility already at an all-time low within the City Fringe, the ‘new style’ of occupier was dominated by smaller start-ups, keen to remain as agile as possible in the face of shorter term business planning and the ever evolving marketplace. The result was a self-fulfilling prophecy (See Graphic 1).
Varying business sectors can also exert an impact on lease lengths, with the nature of the operators and the business models often dictating the importance of continuity in terms of real estate commitments (see Figure 7).

Out in front in 2018 are, not unexpectedly, the public sector and flexible offices business groupings. Over the past five years, Colliers International has tracked a total of 22 separate deals to public sector bodies within Central London. Just three of these were over 50,000 sq ft, with the two largest being to the Government Property Unit and the Competition and Markets Authority, both 15-year leases at Canary Wharf. Significantly, average public sector leases have only fallen by 10% in the past decade, down from 10.3 years to 9.3 years. In contrast, the equivalent London wide figure fell 46%.

The relatively stable public sector levels should not be surprising. Equally, the flexible offices sector which, by its nature, requires longer lease commitments in order to squeeze value out of the business model, is the other business grouping to have a significantly higher average lease term. Analysing the flexible sector in terms of leases signed over the past two years, the preponderance of leases of 10 years and above is clear (see Figure 8).

Geography also impacts lease numbers within sectors though. While financial occupiers across London agreed to average lease lengths of 6.4 years in 2018, the numbers in the City of London itself were higher at 7.0 years. Looking back over the past 24 months and combining the City core with Canary Wharf, the variation is even more pronounced. In 2017-2018, City and Canary financial occupiers signed for an average of 7.1 years, term certain, compared with the rest of London at just 5.5 years.
SIZE STILL MATTERS

Geography and business planning are certainly major considerations for property managers and advisers when considering lease and real estate commitments. However, while average term certain numbers are falling, the larger end of the market, with the exception of shorter term overspill space, lease lengths remain elevated (see Figure 10). While the sub-10,000 sq ft size bands have fallen sharply decade on decade, downward pressure at the top end of the market, 50,000 sq ft plus, has been markedly less explicit. Such movement, or relative shortage of it, should not surprise. Typically, London occupational deals over 50,000 sq ft are for better quality accommodation. Since 2009, 73% of units leased over 50,000 sq ft, have been either of new/refurbished quality or taken on a pre-let basis (see Figure 11).

The story remains consistent when one looks at lease term certain by size band and quality. As expected, pre-letting lease lengths have remained the most resilient, with landlords still keen to secure longer term commitments in order to protect asset and investment values. None of the differing quality categories, for 50,000 sq ft plus units, have fallen below 10-year term certain over the past decade.

The nature of development funding for large scale schemes necessitates greater certainty in terms of occupation timelines. Minimum lease terms certain, in conjunction with generous incentive packages and ongoing asset management, enable developments to manage voids as efficiently as possible.

But there are new players in town, who are abiding by very different rules. Flexible offices providers are continuing their push to secure larger scale commitments from blue chip and corporate occupiers, the prime client base for the new ‘live’ schemes. However, the appetite for such space, from more ‘conventional’ professional and financial services occupiers in London, is still difficult to gauge.

Certainly, Facebook has signed for 140,000 sq ft at WeWork’s 125 Shaftesbury Avenue, WC2, centre, in order to contain overspill prior to the completion of its major new 600,000 sq ft hub at Kings Cross. We await to see whether a major UK-based financial blue chip is prepared to decant large numbers of teams, en masse, for open ended timescales, into genuine co-working space.

The greater likelihood appears to be using major providers like WeWork, as ubiquitous touchdown space. Figures suggest that 30% of its membership globally is derived from corporates such as Microsoft, Barclays and Deloitte. Business development, networking, access to talent and, above all, breaking down of closed off ‘corporate’ mentality, appear to be the key drivers. At present, WeWork’s offering of ‘Space As A Service’, specifically targeting corporate occupiers in order to create and maintain a modern, vibrant and innovative workspace for staff, seems to be finding favour with small to medium sized companies rather than industry behemoths.

Source: Colliers International
WHAT FLAVOUR ARE YOU?

The REITs and landlords are responding, though, with British Land (Storey), Land Securities (MYO), Brockton (FORA) and HB Reavis (HubHub) to name just a few. All this is fuelling the drive of flexibility and, above all, the search for ‘sticky’ tenants. ‘Evolution occupation’ is more important than ever. Where feasible, landlords with larger scale product are looking to create organic real estate. The 100,000 sq ft building/multi-level unit of the future may embrace the following:

Lower Levels
Easy access, providing in flex/co-working options for visitors and tenants, in tandem with fixed/stand-alone units for small scale existing operators. Space offered on short basis. Monetisation of additional services.

Mid-Levels
Professionally managed office space on mid-levels, most likely through branded offering from the landlord themselves or possibly third party provider. Highly flexible leasing strategy at all inclusive price point.

Upper Levels
Conventionally leased space on 5-year plus term certain. Multiple size options to encourage organic growth of maturing occupiers already present within the building.

Tenant, occupier or community member. However landlords or providers treat individuals or companies seeking office and work space, the goal is the same: keep the customer satisfied. Perhaps that should read “keep the customer hungry for more”, and that means providing a variety of flavour options that appeal to the discerning and less discerning pallet alike. Equally, the more customers like the dish being put in front of them, the greater their desire to become more adventurous in their tastes and outlook.

Statistics, for once, don’t lie. The quantifiable reduction in lease lengths and the clamour for flexibility are impacting occupational and investment markets alike. There will always be businesses that will want to brand real estate and see it as very much a reflection/extension of the corporate ethos and identity, stable, long-term and immutable. This viewpoint is being increasingly challenged and now seems to stand at odds with market forces. That said, while many are happy to embrace flexible providers’ preferential ‘sign-up’ deals and avoid unplanned for balance sheet activity for fit-out costs etc., the bargain basement offers cannot last forever.

For the majority of London occupiers, flexible offices remain a means to an end rather than the end itself. Regardless, the concept is here to stay and the impact upon lease flexibility has accelerated in the past five years. Given the flattening of average lease lengths in 2018, it is not unreasonable to suggest that we may be close to bottom. Political uncertainty, supply issues for conventional space, the quest for workspace vibrancy in conjunction with the war for talent and balance sheet concerns, are all combining to influence lease lengths. While greater political certainty may be within grasp, the influence of key sources of demand, in terms of media and tech and the wider service sector, will continue to operate in an environment built upon flexibility, adaptability and innovation.

SUMMARY

Disruption and structural shifts are permanently altering the traditional principles of occupation and leasing.

Average lease length between 1996–2018 was 12.7 years, putting current levels (5.6 years) at over 50% below the long-term trend.

Geography continues to play a role in lease flexibility. Although the majority of London submarkets are below the average level of 5.6 years, Canary Wharf has continued to stay at a level (9.8 years) well in excess of the market norm.

The differing needs of the wide variety of business sectors in London is a key factor in driving down lease lengths. Public sector leases have only fallen by 10% in the past decade, compared to the London-wide equivalent of 46%.

Media and tech, so influential across London, has had a quantifiable impact upon lease flexibility within City Fringe locations. Average lease length to media and tech occupiers is down from 20 years in 1996 to its current level of four years.

Sub-10,000 sq ft size bands have seen lease term certain figures fall sharply in the past decade, down by over 50%, but movement on 50,000 sq ft plus units, has been modest, down by just 25%.

Attitude towards tenant and occupiers is changing rapidly, driven by the likes of WeWork and increasingly influencing major landlords with multi-million sq ft portfolios.

The quest for flexibility will continue, but evidence suggests that occupiers in certain business sectors remain wary of overexposure to co-working.
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