

# City and West End Rent Differentials

November 2007

## KEY FACTS

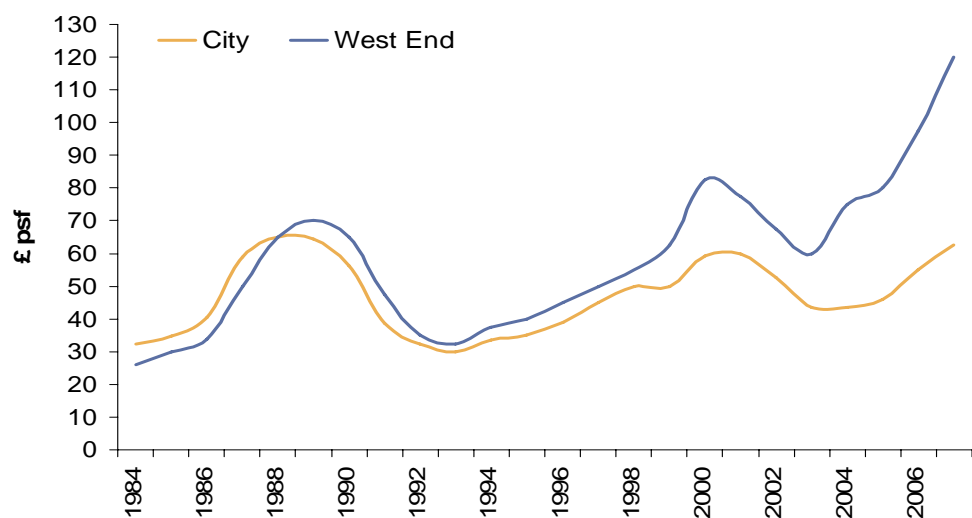
- Top prime rents are nearly 50% lower in the City than the West End (Mayfair) – the largest ever disparity between the two markets.
- Faster rental growth in the West End has been mainly driven by severe supply constraints. Since 1984, the stock of office space in the West End has grown by just 12% compared to 36% in the City.
- Only a small percentage of tenants pay rents close to the top prime rents. This is particularly true of the West End market. Over the last 12 months only 10% of West End deals were within 80% or more of the market's top prime rent. The equivalent figure for the City is 24%.
- Top prime rental differentials are a poor guide to the discounts available to most tenants by switching between markets.
- The growing disparity of top prime rents between the two markets is unlikely to act as a brake on top prime West End rents.

## INTRODUCTION

London is considered the world's most expensive office location. At £120.00 per sq ft, top prime rents are higher in Central London than anywhere else. It has been argued that these high tenancy costs might hinder London's competitiveness. However, this headline figure refers only to the West End market and, in fact, just one part of that (Mayfair & St James's). Rents are much lower in the City at £62.50 per sq ft and – as we shall see – are cheaper in most West End sub-markets. So the top prime rent in the West End is not an indication of typical Central London rental costs.

Top prime City rents are approximately half top prime West End rents, the largest ever difference between the two markets. The large differential in rents may impact on the internal dynamics of the Central London market. There are increasing expectations that tenants will start to move out of the West End market raising questions about the sustainability of the market's rents. This paper explores the significance of these differentials, identifies the drivers of the different rental trends and assesses the impact of the disparity on rental growth.

Graph 1: City and West End Top Prime Rents

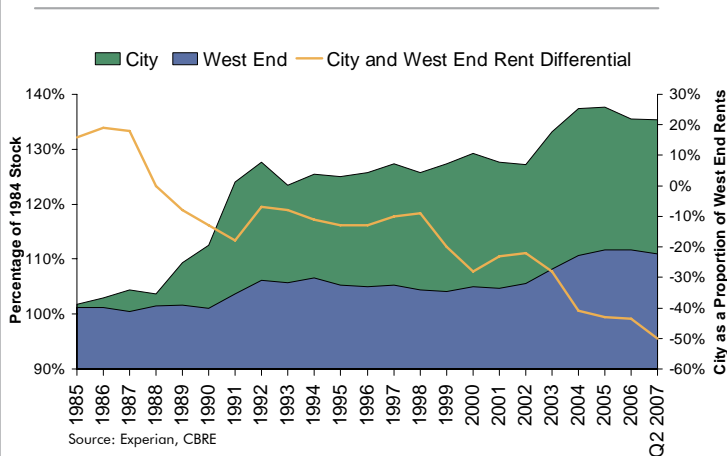


Source: CBRE

The divergence in top prime rents in the City and West End is part of a long term trend. At the start of the 1980s, City rents were higher than West End rents. In the late-1980s boom, West End rents overtook City rents and they have remained higher ever since.

With each rental hike, West End prime rents have turned upwards earlier and risen more quickly. Indeed, the current rental upswing started earlier, has been faster and will last longer in the West End than the City. The long-term drivers behind this trend are examined here.

Graph 2: Growth of Office Stock & Top Prime City Rents as a Proportion of West End Top Prime Rents, 1985 - 2007



## SUPPLY AND DEMAND

Whereas top prime rents in the City were about 20% higher than West End rents in the mid-1980s, they are now around 50% lower. Fundamental differences in the supply and demand conditions in the two markets explain this long term trend.

The West End is a supply constrained market due to the prevalence of a conservative planning regime. Conservation areas cover around 76% of Westminster and it homes 11,000 listed buildings. Consequently, the growth of stock has been very slow there compared with the City. Since 1984, the amount of office space has increased by just 12% in the West End, significantly less than the 36% growth witnessed in the City.

As Graph 2 shows, City office stock grew particularly quickly between 1988 and 1993 when the City of London relaxed planning policies in response to emerging competition from Canary Wharf, which offered new buildings with large floorplates and good incentives.

Faster supply growth in the City is set to continue (see Graph 3). Over the next three years, over two-and-a-half times more floorspace will be completed in the City compared with the West End. In addition, a significant number of refurbishments will also ease supply constraints in the City.

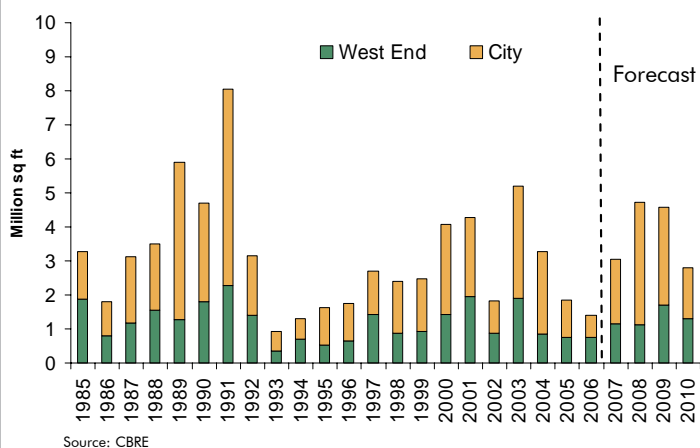
The emergence and evolution of the Docklands and Southbank markets has also increased the stock of space traditional City tenants would consider as a potential office location. Over 20m sq ft of office space has been added to these two markets since 1984. In contrast, we have not seen significant alternative markets emerge for typical West End tenants.

On the demand side, the principal driver of demand for Central London office space is financial and business service employment. Banking and finance, business services and insurance together accounted for two-thirds of office take-up over the last 12 months. There are now nearly 760,000 financial and business service sector jobs in Central London, up from about 430,000 in 1984. Both the West End and the City are home to around a third of these jobs.

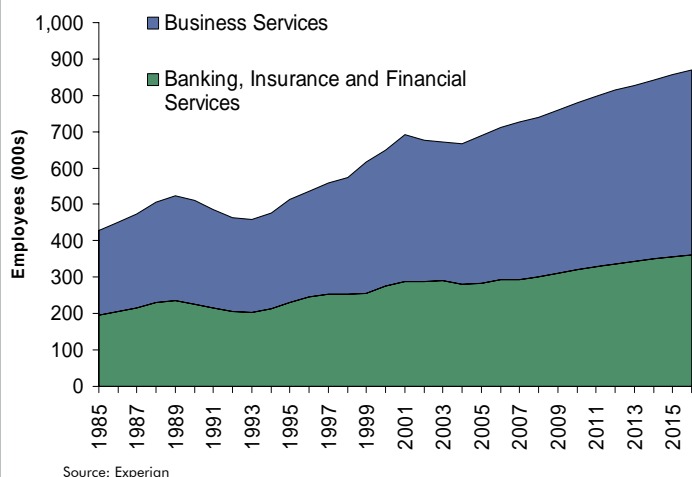
In the West End, business services dominate while in the City, the banking and finance sectors are more prominent. There are also significantly more tenants from the insurance sector in the City. So banking and finance accounted for 46% of take-up in the City compared to 26% in the West End, whilst business services accounted for 30% in the West End but just 11% in the City (see Graph 5).

Employment in business services have grown more rapidly than banking and insurance. This feature of demand is one of the explanations behind the stronger rental performance of the West End.

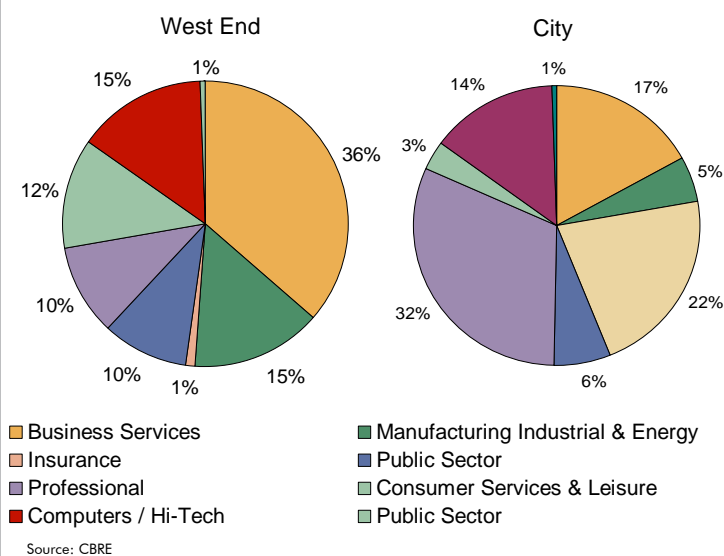
Graph 3: City & West End Developments, 1985 - 2010



Graph 4: Financial and Business Service Employment in Central London, 1985-2016



Graph 5: West End & City Take-up by Sector: 1998 – November 2007



Between 1985 and 2006, Central London employment in banking and insurance grew by 39% while the number of jobs in business services grew by 84%. Similar rates of growth are forecast to persist over the next ten years. This suggests demand has grown more quickly in the West End. Indeed, in the rate of growth of financial and business service employment has been slightly slower in the City since 1985, increasing by 46% as opposed to 53% in the West End. As we have seen, this rapid increase in demand was not matched by supply as West End stock grew by just 12% over the same period (see Graph 2).

**PRIME RENTS**

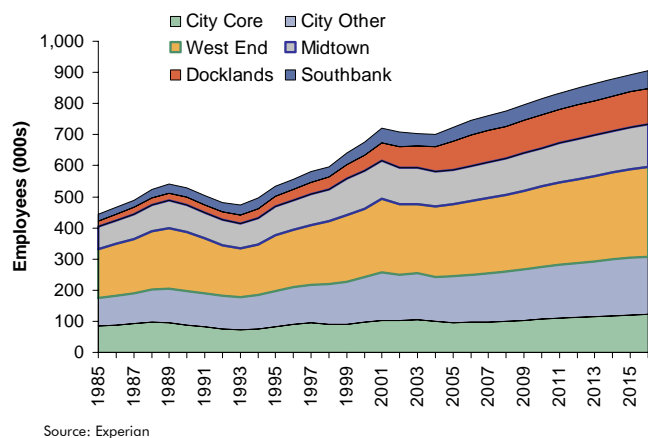
Despite the evident difference between the City and the West End, caution must be exercised in assessing the significance of top prime rent differentials. Only a small percentage of transactions are at rents close to the top prime rent but the variance from these figures differs markedly between the City and West End.

In the West End, prime rents are only applicable in the sub-markets of Mayfair and St James’s. Indeed, when deals are ranked in terms of cost relative to the prime rent, 48 of the 50 most costly deals done in the second half of 2006 and first half of 2007 were in Mayfair and St James’s. The most expensive deals in Victoria and the North of Oxford Street sub-markets are to be found way down the list ranking 64<sup>th</sup> and 67<sup>th</sup> respectively. The top deals in the Soho, Strand and Covent Garden markets fall outside the hundred most costly transactions at 102<sup>nd</sup>, 113<sup>th</sup> and 140<sup>th</sup> respectively.

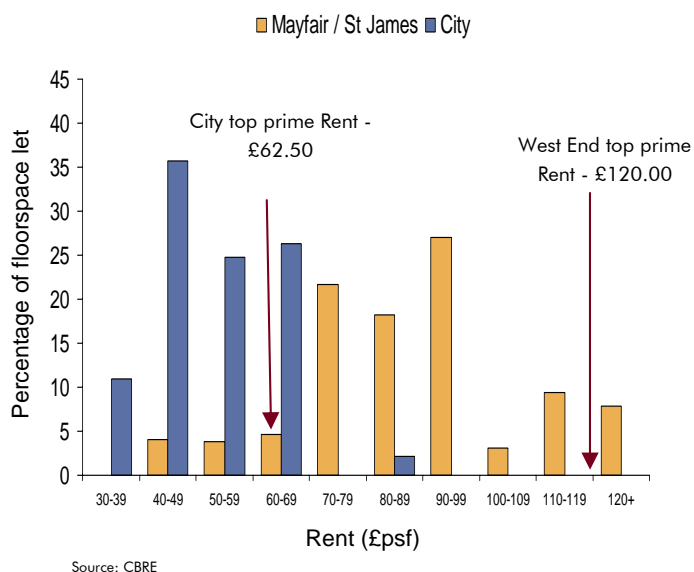
Analysis of the spectrum of rents paid reveals that top prime rents are a poor guide to the rental costs faced by most tenants. This is the case in both markets but especially the West End. In the City, 42% of floorspace was let at rents over 80% of the prime rent in the 12 months to June 2007. In the West End the same applied to only 11% of floorspace let. The variation from top prime rent by proportion of deals provides similar results. Around 25% of deals done in the City were at rents of over 80% of the top prime rent. The equivalent figure in the West End was just 10%. Indeed, the majority of deals in the West End were let at less than half of the top prime rent.

Much of this may have been surmised from examination of the variation in top prime rents across West End sub-markets (see Table 1). What is more surprising is that, even in Mayfair, where West End top prime rents are achieved, only 37% of floorspace was actually let at rents of 80% or more of the top prime rent. Only around a quarter of letting transactions fall into this rental band as most deals were done between 40% and 80% of the top prime rent.

Graph 6: Financial and Business Service Employment by Sub-Market, 1985-2016



Graph 7: Distribution of Rents on Grade A lettings, Q1-Q3 2007



The top prime rents of the West End are being driven by a relatively small number of tenants that have strong preferences for very specific locations in the West End core (see Map 1). There has been a structural change over the last decade with a rapid increase in West End financial tenants. Of the 50 most expensive deals between Q3 2006 and Q2 2007, investment managers, private equity firms and hedge funds have accounted for 50-60%. They are relatively price insensitive tenants.

Significantly more deals are done at rents close to the prime rent in the City compared to the West End. Top prime rents are therefore reflective of a much smaller number of deals in the West End than in the City. Looking solely at top prime rents may overstate the change in the rent differential between the City and West End for most occupiers.

## FUTURE TRENDS

The growing differential between City and West End top prime rents is very unlikely to act as brake on West End rental costs. Tenants paying top prime rents in the West End could make very significant rental savings by moving to the City but they do not consider the markets to be substitutes. Cultural differences mean high-end West End tenants cannot see themselves in the City, fearing loss of staff and clients. Where cost is a push factor, West End tenants are increasingly considering moving back office functions to the City whilst maintaining a small, high profile West End presence.

Very few tenants move between the two markets. During the dot.com boom, some movement took place but driven by lack of availability rather than lower costs.

For tenants paying significantly less than the top prime rent, the wider spectrum of rents paid in the West End means the potential rental savings are not as large. The difference in the median rent paid during the second quarter of 2007 is much smaller than the difference in top prime rents: in the West End it was £49.50 per sq ft compared to £35.00 per sq ft in the City, a 30% discount. Such a discount is less likely to trigger movement between distinct markets. Indeed, if tenants are to seek cheaper accommodation, they are more likely to relocate to alternative markets. Midtown and Southbank have emerged as potential locations for West End tenants. Redefined by a number of major image-changing schemes, Victoria is now a stronger candidate for traditionally West End core tenants. The further development of Paddington and increased supply at King's Cross will provide attractive options.

The differential could widen further. Future trends in top prime West End rents will largely depend on the fortunes of the hedge funds, investment managers and private equity companies that are driving the rents paid in Mayfair & St James's submarkets. A narrowing of City and West End Rent differentials is only likely if such tenants become less active or more cost-sensitive in a less profitable business environment.

Map 1: Hedge Funds in the West End

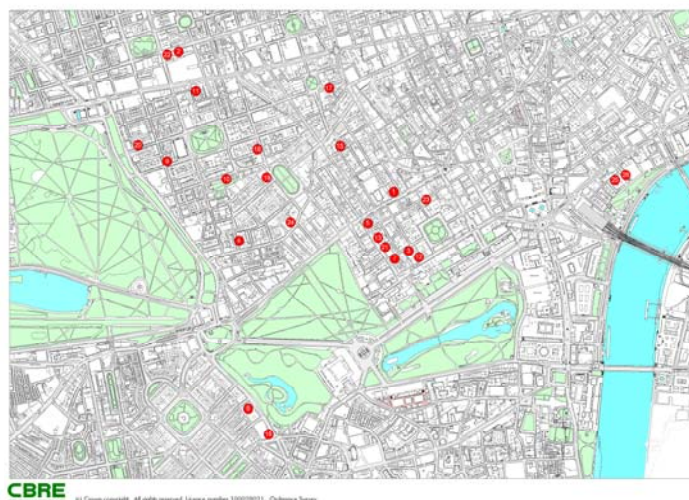


Table 1: Top Prime Rents and Stock in West End Sub-markets, Q3 2007

West End Sub-market	Top Prime Rent (£ PSF)	Percentage of West End Stock
Mayfair	120.00	17%
St James's	120.00	15%
Belgravia/Knightsbridge	90.00	4%
North of Oxford Street	80.00	10%
Victoria	67.50	23%
Soho	62.50	6%
Covent Garden/Strand	65.00	9%
North of Oxford Street East	62.50	8%
Paddington	55.00	1%
Euston	50.00	3%

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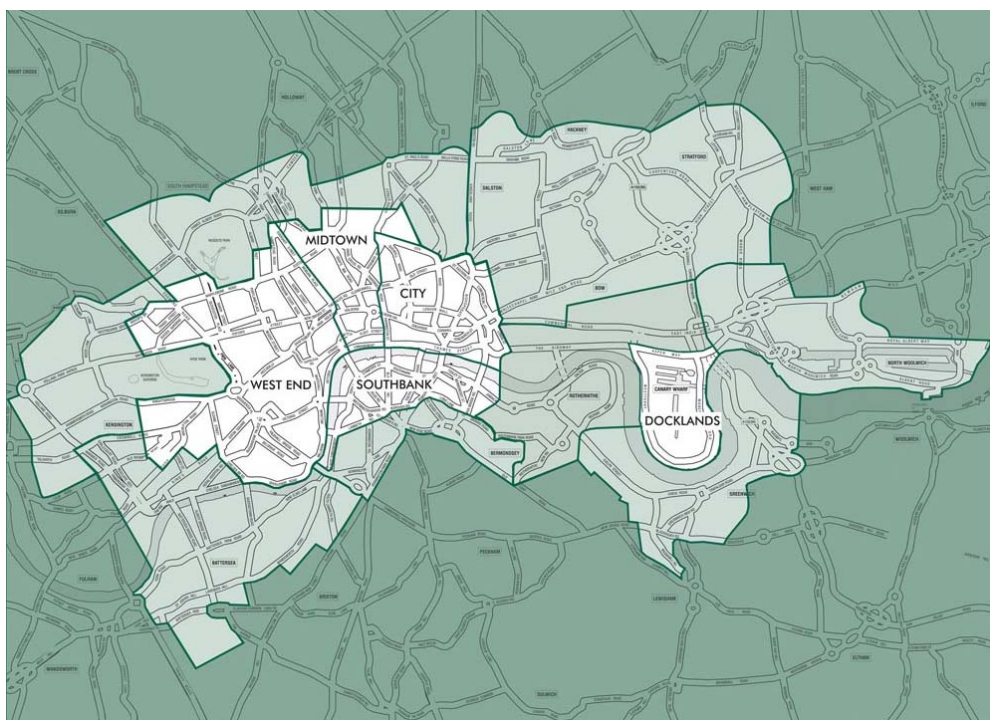
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### SUBMARKET MAP



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