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Are the tables turning for London offices?

March 2025

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Executive summary

Are the tables turning for London's offices?

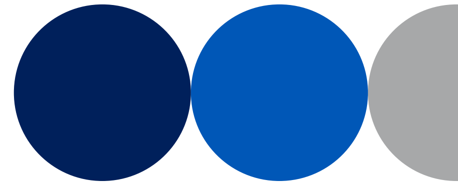
The pandemic has had a significant effect on offices. And it has left a lingering question over the sector: what's next? With vacancy rates in London submarkets surpassing 20%, office attendance barely accounting for half of the working week, and values down 25% over five years, the outlook may appear bleak. But our research shows there are segments of the market certainly worth exploring.

Our previous **FACTS** papers (abbreviated from flexibility, amenity, connectivity, technology, and sustainability) laid out our post-Covid framework for future office performance. It made the investment case for value-add offices clear. Two years after the end of any Covid restrictions, the case for value-add offices in central London hasn't only held up, evidenced by significant prime outperformance over the wider sector, but the window of opportunity remains open.

The concept of FACTS has evolved since those early days, and the depth of specialism required for effective product delivery can't be overstated. Choosing the right location is crucial and delivering the right amenities is equally important to satisfy occupier and employee preferences. Navigating the complexities of development requires a specialist partner with the right market knowledge and value-add experience.

"Choosing the right location is crucial and delivering the right amenities is equally important to satisfy occupier and employee preferences."

Mapping global office markets



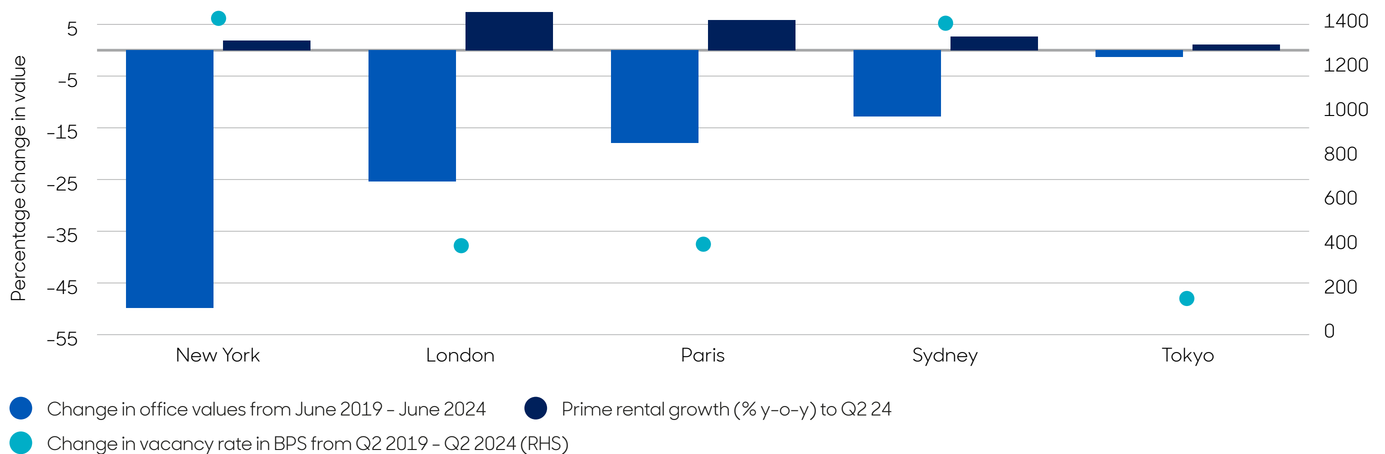
Compared with five years ago, the world, and commercial real estate, finds itself in a very different place. The pandemic brought shifts in demographics, immigration, politics, and economic and fiscal policy. The full effects of these are still playing out.

Since we began our FACTS series in 2021, data has made it abundantly clear that the global office market needs to adapt. Offices have suffered similar fates over recent years across major global cities. Cushman & Wakefield[1] reports that vacancy rates across 18 key North American markets have risen 1,100 basis points (bps) to over 20% since the fourth quarter of 2019. This compares with average increases of 600bps to 15% across APAC, and 450bps in Europe to 10.5%. London's vacancy rate of around 8% therefore seems relatively resilient.

JLL[2] reports that the latest prime vacancy rate in New York is 8.4%, which is well above London's sub-2% rate for its best-in-class space. Meanwhile, Paris's vacancy rate has increased by roughly the same amount as London's, yet overall office values have performed comparatively better in the French capital, despite having weaker prime rental growth. This resilience could be partly a result of much lower interest rates in Europe compared with the UK. A notable exception is Tokyo where the office market has essentially stalled, with only a small increase in vacancy rates. Given Tokyo's office-centric nature with high attendance rates, and near-0% interest rates, this is not entirely surprising.

This hints at themes that have real implications for office performance, such as local culture, workforce demographics, location and accessibility. These factors contribute to performance far more than a few years ago. Regardless of the market, a growing obsolescence in offices looks set to continue. Cushman & Wakefield[3] estimates that 76% of London stock is at risk of becoming obsolete by 2030. And stringent EU regulations introduced as part of the Energy Performance of Buildings Directive (EPBD) are set to render large swathes of the continent's office market obsolete, without significant capital expenditure, in a little over five years from now.

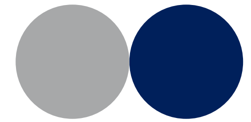
Chart 1: London has experienced a substantial correction in values, but also strong prime rental growth



Source: MSCI-IPD Quarterly Index, Aberdeen Investments 2024[4].

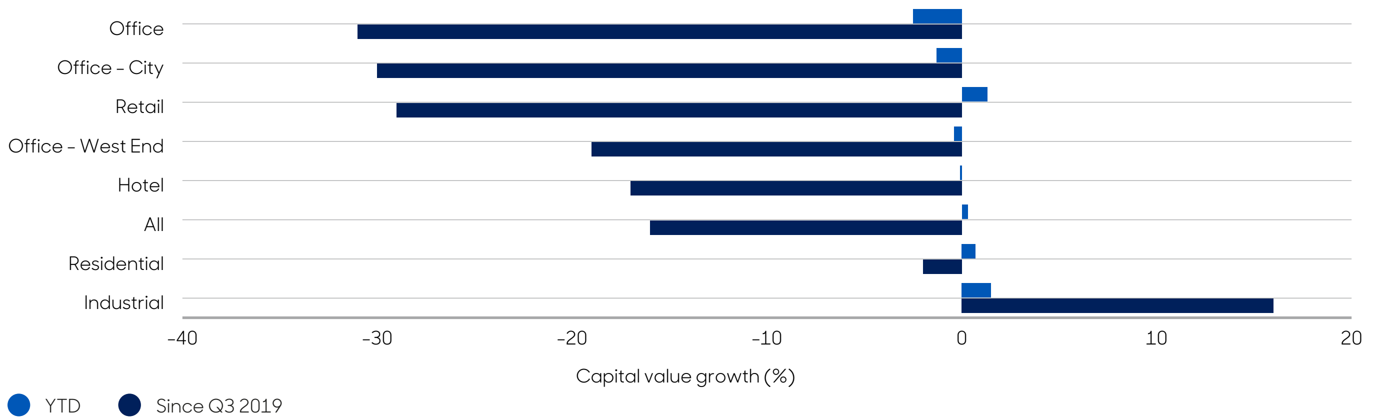
[1] Global MarketBeats, Map, Cushman & Wakefield.
[2] Subscription data.
Previous FACTS papers:
Offices: getting our FACTS right, Aberdeen Investments.
Offices: re-evaluating the FACTS, Aberdeen Investments.
[3] Rethinking European Offices, Cushman & Wakefield.
[4] Subscription data.

Appraising UK offices



According to Real Capital Analytics[5], offices made up 46% of UK investment volumes in 2014. As the popularity of the industrial and logistics, alternative, and living sectors has grown, the relative share of offices in overall volumes declined. Even in 2019, volumes were still a healthy 36%. In 2024, this share dropped to less than 20%. Offices have become the standout 'ugly duckling' over the past five years. That said, the West End and City submarkets have suffered less of a correction over the past five years, supported by different drivers (see chart 2).

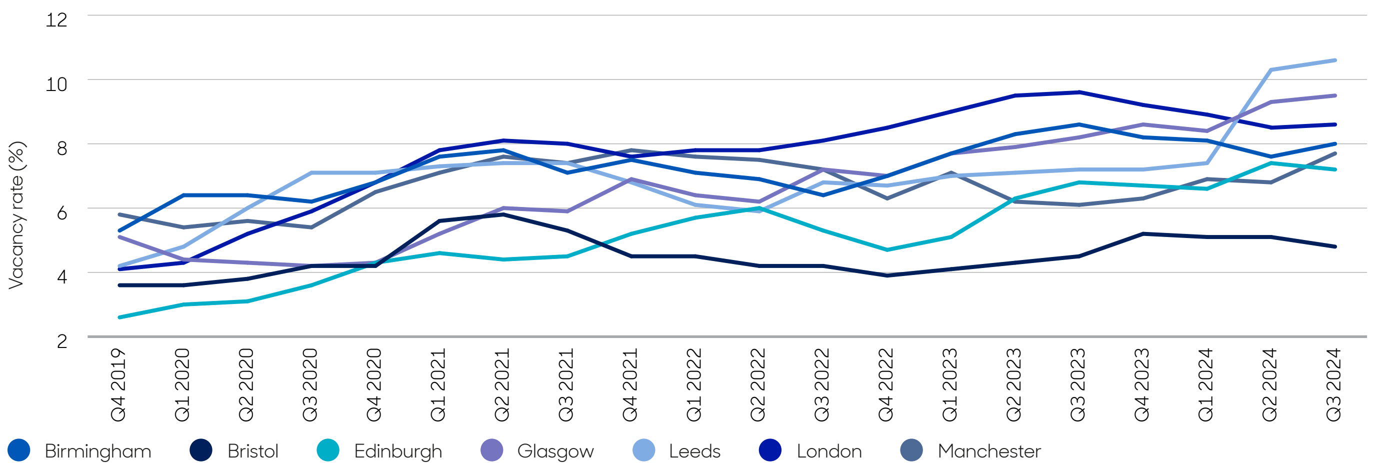
Chart 2: Offices have significantly rebased, but this decline has slowed markedly over 2024



Source: MSCI-IPD Quarterly Index, Aberdeen Investments 2024[6].

In 2019, vacancy rates for offices in the UK were either at or near their historic lows. The availability of space was dwindling across the 'big six' markets and, combined with robust demand, prime rents were being pushed up. A healthy supply pipeline provided positive tailwinds to the investment market, and prime yields stabilised during a sustained period of low interest rates. Today, vacancy rates stand at 8% in central London and they are higher in struggling regional markets. A lack of transactional evidence has also cast doubts on appropriate pricing.

Chart 3: Increasing vacancy rates have affected most UK markets



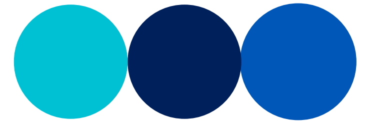
Source: JLL, Aberdeen Investments 2024[7].

It would have been all too easy to write off the office sector given the headwinds. Instead, as we have outlined in previous FACTS papers, the evolution of offices has raised parts of the sector to prominence and is quashing swathes of space from relevancy.

We are now in a fully polarised market. Choosing the right office product in the correct location is both challenging and imperative to a competitive strategy – whether from the perspective of an occupier or investor.

[5] Subscription data.
[6] Subscription data.
[7] Subscription data.

Notes on office attendance



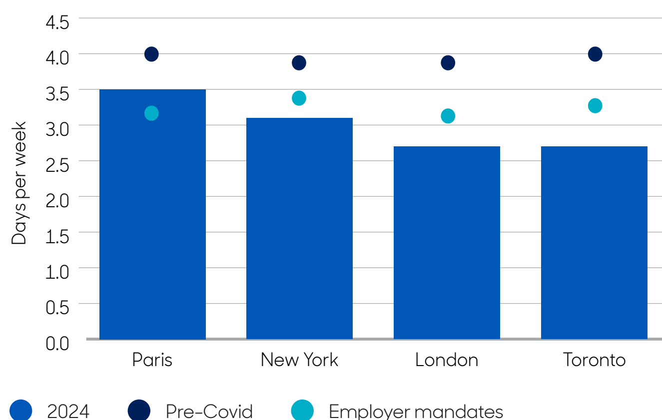
Office attendance prior to 2020 averaged four days per week across global cities, according to Centre for Cities[8] research. This was reflected in central London. But a 2022 report by King's College London[9] highlighted a growing pre-pandemic trend towards flexible working arrangements, with 37% of respondents working from home at least one day per week. The extent to which hybrid working would have been adopted without the pandemic will obviously remain unknown. What we do know is that hybrid working has fundamentally changed the office market.

This change has challenged our understanding of employer, employee, and underlying human behaviour. We would like to say the data is clear-cut, showing a gradual 'U-shaped' recovery to a new baseline, but nothing has proven that simple. A number of factors outside of FACTS contribute to office occupancy, including sector of employment, demographics, days of the week, and, importantly, culture. According to the latest Centre for Cities research, London lags its global competitors in Paris and New York, with office attendance at 2.7 days per week (see chart 4). Poor in-office numbers on Fridays act as an extra drag, but this comes from already low mid-week numbers. Both travel costs[10] and commuting time were cited by respondents as a primary driver behind working from home more regularly.

Employer mandates are increasing among London's global peers. In the US, JLL[11] reports a country-wide average of 3.3 days are required in offices for Fortune 100 companies. This narrows the suburbia-driven gap to the more office-centric market of New York, which stands at 3.4 days. Paris mandates 3.2 days, and its office attendance is higher and relatively close to its pre-pandemic standard. Notably, French employers are legally required to subsidise employees' public transport costs. London lags its peers in this respect at just 3.1 days per week. Additionally, only 81% of employers in London use mandates, compared with 87% for both New York and Paris.

We believe there could be upside potential to these numbers. While employees have been slow to return to the office, London's employers have also been reluctant to increase mandates, given concerns over employee retention. For employers imposing mandates, they typically aren't regulated or tracked given the same fears of employee retention, according to Centre for Cities research. The same research suggests these fears are overblown, as fewer than one in 10 employees in London would look for another job if mandated days increased. This suggests there could be further room for improvement in these metrics, especially if transport costs are addressed. In turn, increased attendance could support demand for additional floorspace.

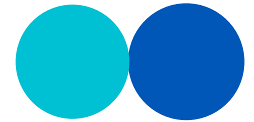
Chart 4: London's attendance and mandates lag global competitors



Source: Centre for Cities, Aberdeen Investments 2024.

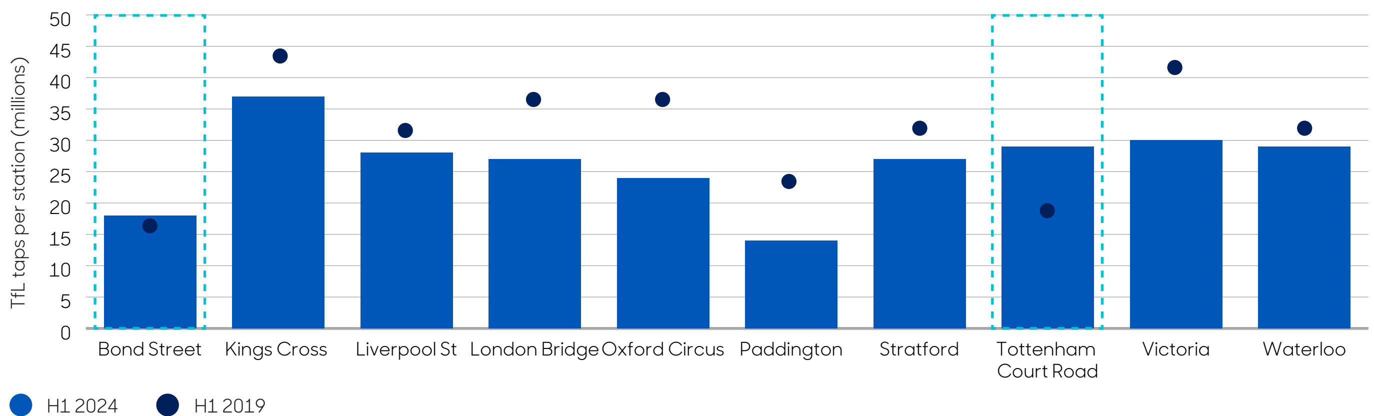
[8] Return to the office, Centre for Cities.
[9] The WFH revolution: how new ways of working are changing London, King's College London.
[10] In March 2024, Transport for London (TfL) ran a three-week trial removing peak fares on Fridays to boost office attendance. Despite poor awareness, over half of those aware of the trial changed their travel patterns, indicating that even minor subsidies can encourage employees to commute without harsh mandates.
[11] U.S. Office Market Dynamics.

Commuting to London's offices



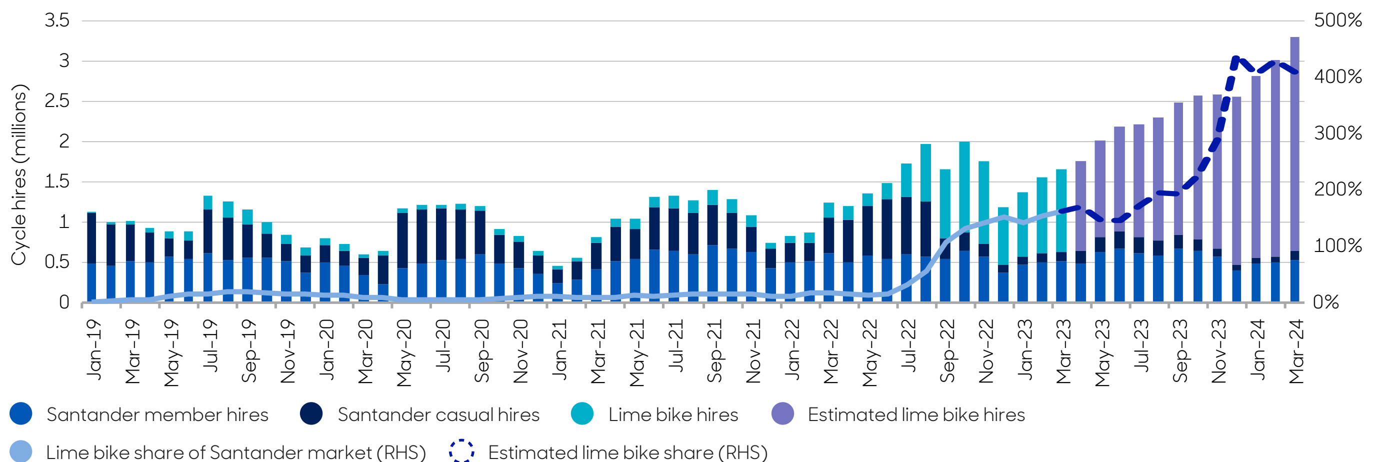
According to Transport for London (TfL) data[12], central London's travel numbers for the top 10 busiest stations over the first half of 2024 have stalled at around 85% of the levels seen in 2019. Depending on the location, this 15% structural gap helps to explain the 20% gap in office attendance rates over the same period. The notable exceptions to this trend are Bond Street and Tottenham Court Road stations, highlighted in chart 5, both of which are benefiting from the new Crossrail (Elizabeth Line) connection.

Chart 5: New Elizabeth line connections are outperforming



Source: Steer, Transport for London, Aberdeen Investments 2024.

Chart 6: Dockless cycle hires are increasing central London accessibility



Source: Steer, Transport for London, Aberdeen Investments 2024.

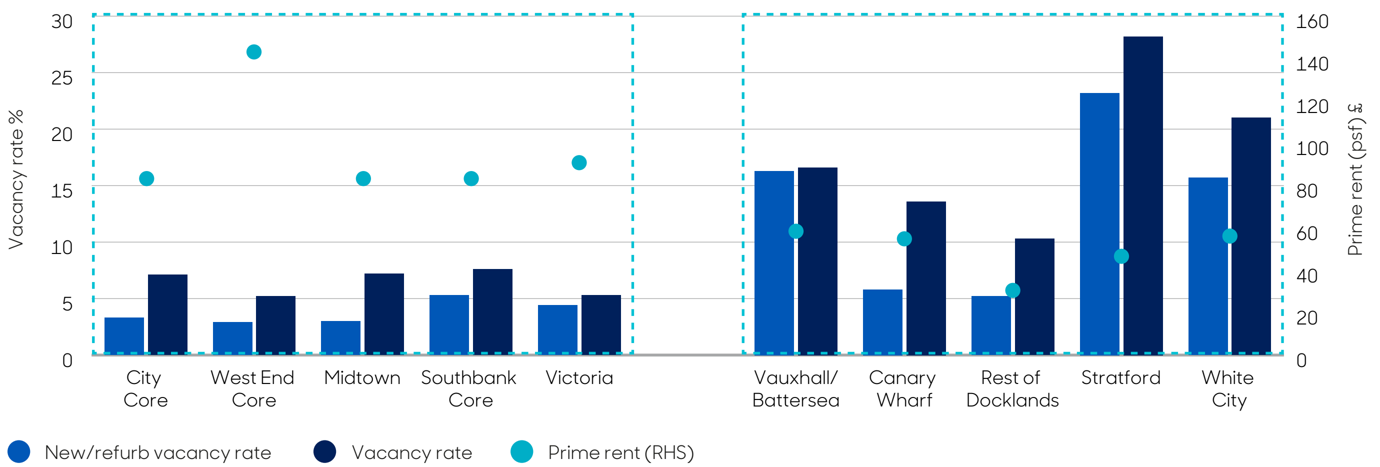
The exploding popularity of dockless cycle-for-hire schemes has improved connectivity between submarkets and provided more accessible options for commuting. Taking the largest of these private providers as an example, Lime's electric cycle hire numbers have quickly dwarfed Transport for London's own hire scheme over the past two years, (see chart 6)[13]. We expect further gains in this area as competition between these cash-backed brands ramps up. Looking more broadly, total daily cycle trips within inner London are estimated to have increased 20% between 2019 and 2023, according to TfL's annual report. This accounts for 15% of all commuting trips within central London. As the rebound in public transport trips seems to have plateaued, this trend suggests a plausible mode-of-transport shift, which office occupiers and investors could take advantage of in their amenity offering.

[12] Our open data - Transport for London.
[13] Steer presents vision to boost London's already booming bikeshare schemes with new report, Steer.

Mind the location gap

With travel trends as context, consider the following as supportive evidence of the 'C' (for connectivity) of our FACTS framework. Occupier preferences increasingly show a premium based on location. Knight Frank's vacancy data indicates that core submarkets outperform peripheral ones, with tighter vacancy rates and higher prime rents. Knight Frank[14] and JLL[15] data reveals an 80% premium on central London prime rents within Zone 1 versus outside (see chart 7). There is an additional premium for future-fit buildings with the best transport links. Improved accessibility and simplified commutes are increasingly linked to greater office performance, with Costar[16] citing vacancy rates being 200bps lower within 0.2 miles of London's largest rail hubs. Vacancy rates for more peripheral submarkets are even higher, highlighted on the right side of chart 7.

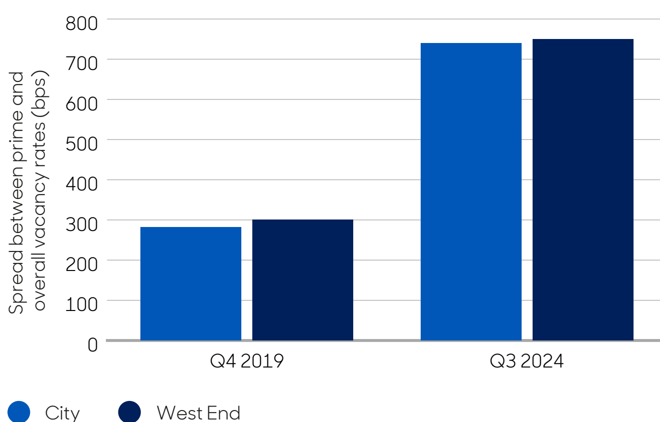
Chart 7: Core submarkets markedly outperform peripheral submarkets



Source: Knight Frank, JLL, Aberdeen Investments 2024.

Despite overall vacancy rates of around 8%, the availability of prime/new-build space in London remains below 2%. JLL data[17] shows Grade-A/new-build vacancy rates are at 0.6% for the City and 0.4% for the West End, down from long-term averages of 1.1% and 0.8%, respectively. Overall vacancy rates are 200-300bps higher than long-term averages for these submarkets, but the increasing popularity of prime space is clear in chart 8.

Chart 8: Prime space is clearly more favourable for occupiers



Source: Knight Frank, Aberdeen Investments 2024.

In the City and West End submarkets, the spreads between average and prime vacancy rates have increased significantly since Q4 2019, as secondary space is left behind.

[14] Intelligence Lab – Property and Market Research and Insights, Knight Frank.
[15] Subscription data.
[16] Subscription data.
[17] Subscription data.
[18] London Offices Spotlight – Q3 2024, Knight Frank Research, The London Office Market Report – Q4 2019, Knight Frank Research.

Mind the location gap

The drive for FACTS-compliant offices is largely driven by the ongoing 'war for talent'. The ability to attract and retain talent is crucial for sustaining productivity and maintaining a collaborative workplace environment. With London's office attendance lagging its peers and limited signs of in-office mandates returning, employers wishing to attract and retain talent must first and foremost make office attendance accessible and efficient. They also need to provide the most appropriate workplace environment for the future.

This struggle for talent retention is not a new phenomenon, nor is the preference for a well-located office. In a 2019 report, Savills[19] highlighted employers have long recognised the benefits of having happy, productive employees. Although many of the key workplace trends captured by Savills remain relevant, the focus today has been refined to focus on health and wellbeing, flexibility, and inclusivity.

[19] Savills UK | Savills What Workers Want Survey.

Amenities that appeal to employees

The amenities offered in modern best-in-class offices have been scaled-up from the prime offices of the 2010s. Gym facilities, cycle storage and end-of-trip facilities, mental wellbeing, healthcare, and childcare facilities are some of the top central London occupier preferences. The majority of these either didn't factor or were considered distinct afterthoughts just five years ago. Instead, the physical aspects of the ideal workplace have much broader standards, such as the cleanliness and comfort of the work area, lighting and temperature, and quality of Wi-Fi. Indeed, Cushman & Wakefield suggests that today's workplace experience must be enticing enough for employees to make the personal investment to visit the office and keep returning.

Beyond amenities, a fit-out that meets growing workplace expectations is equally important in creating office value. Landlord/tenant partnerships can unlock potential value by enhancing tenant experience, achieving higher rental rates, and fostering social value within the building.

Satisfying energy performance certificate (EPC) standards

The risk of obsolescence has accelerated over the past five years. Regulatory risks suggest nearly 80% of European office stock could be obsolete by 2030, according to Cushman & Wakefield. The UK faces similar challenges, with MEES[20] requirements already in place. Landlords and tenants must adapt to future regulations and commit to net-zero goals, as real estate accounts for 40% of the UK's carbon emissions.

Future-fit compliant offices also perform better. Knight Frank[21] found that lease lengths for retrofitted London offices rated EPC A were over a year longer than those rated EPC B, and two years longer than EPC C. Additionally, pre-lets for EPC A spaces averaged nearly six months before completion, compared with two months for EPC B.

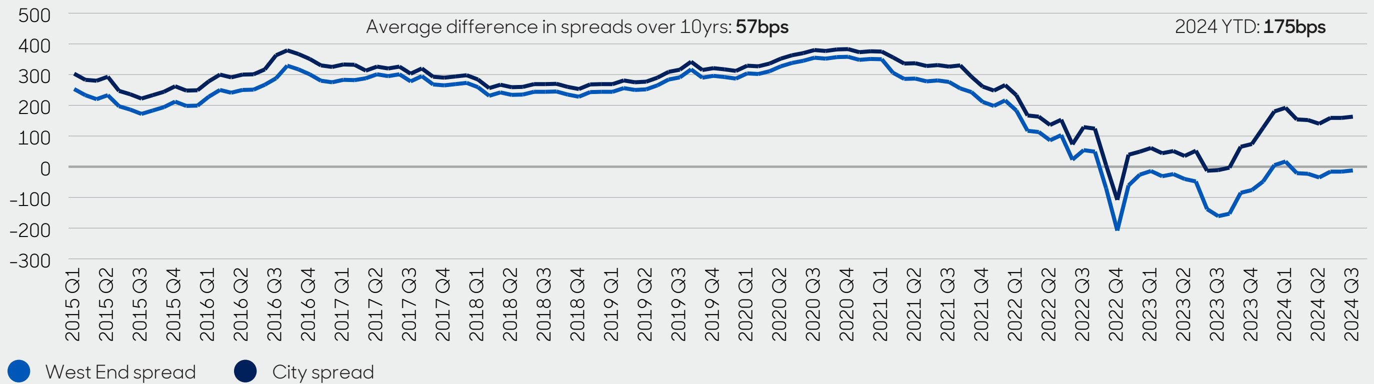
To summarise, there has been a shift in power from employer to employee. The latter holds more bargaining power in the ongoing war for talent. Employers interested in retaining the best and brightest employees must take stock of these preferences and aim for the highest-quality, best-located, and most appropriate space they can afford. They must also satisfy EPC regulations and corporate net-zero targets.

[20] Minimum EPC requirements for commercial buildings set at E in 2023. The minimum EPC rating is likely to be raised further, from E to C by 1 April 2027, and to B by April 2030, according to RICS.
[21] Meeting the Commercial Property Retrofit Challenge - Part 2: The Business Case for Action.

Case study: West End

Perhaps nowhere is this trend clearer than in the West End. Prime rents here have led the rest of central London, with a 4.6% annualised uplift over the past five years, according to JLL[22]. Demand has held up well against the long-term average and the submarket is attracting interest from a diverse range of occupiers. This maintains downward pressure on yields, despite significant outward movement in interest rates. Indeed, offices rated BREEAM 'excellent' or 'outstanding' accounted for 70% of demand within the submarket over the third quarter of 2024, according to Savills[23]. In a notable divergence from the pre-pandemic trend, the West End's prime offices have maintained their values to a far greater extent than those in the City; chart 9 shows their relative performance over five-year gilts.

Chart 9: Prime office values in the West End have been more resilient

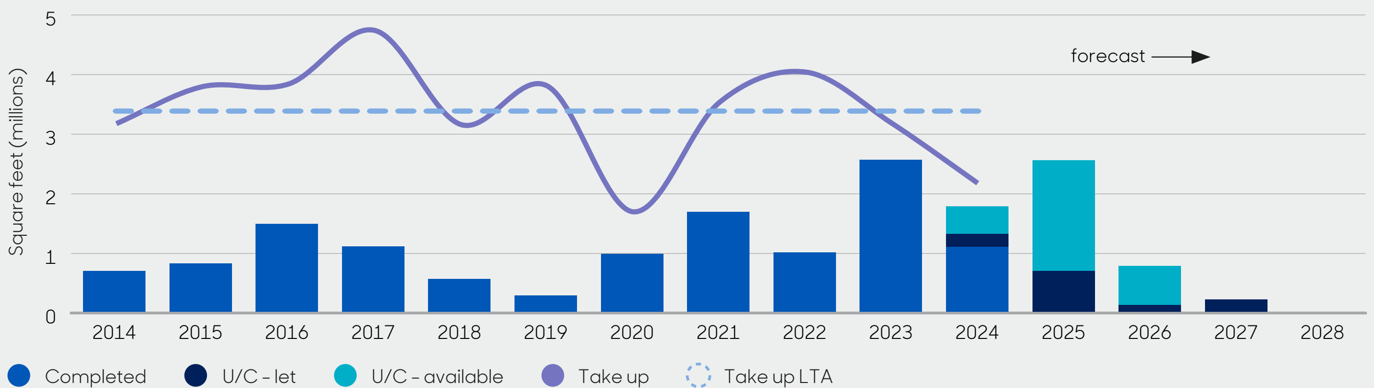


Source: LSEG Datastream, JLL, Aberdeen Investments 2024.

Particularly relevant for the West End story is its historically restrictive planning environment. Westminster City Council is clamping down with further restrictions on carbon emissions from redevelopments. This unique dynamic, combined with consistent demand, has led to a functional supply squeeze as occupiers place more weight on best-in-class space. While the West End presents additional hurdles for developers, those with the expertise and willingness to emphasise net-zero redevelopments today may be able to capture greater upside through increased performance and a reduction in future capital expenditure tomorrow.

Aside from an uptick in 2025, the development pipeline for the West End is slowing, with a sharp drop-off to come in 2026, as shown in chart 10[24]. With around 30% of space already pre-leased, securing the right space is becoming more critical for occupiers.

Chart 10: West End development pipeline



Source: Deloitte Office Crane Survey Winter 2024, JLL, Aberdeen Investments 2024.

Due to these forces, we expect upward rental pressure to continue in earnest here, particularly for well-amenitised buildings in core locations with good transport links. The post-pandemic shifts in the workplace have only strengthened well-positioned buildings and this submarket continues to offer opportunities for those equipped to take on development risk.

[22] Subscription based data.
[23] Savills | Central London Office Market Watch – October 2024.
[24] London Office Crane Survey Winter 2024.

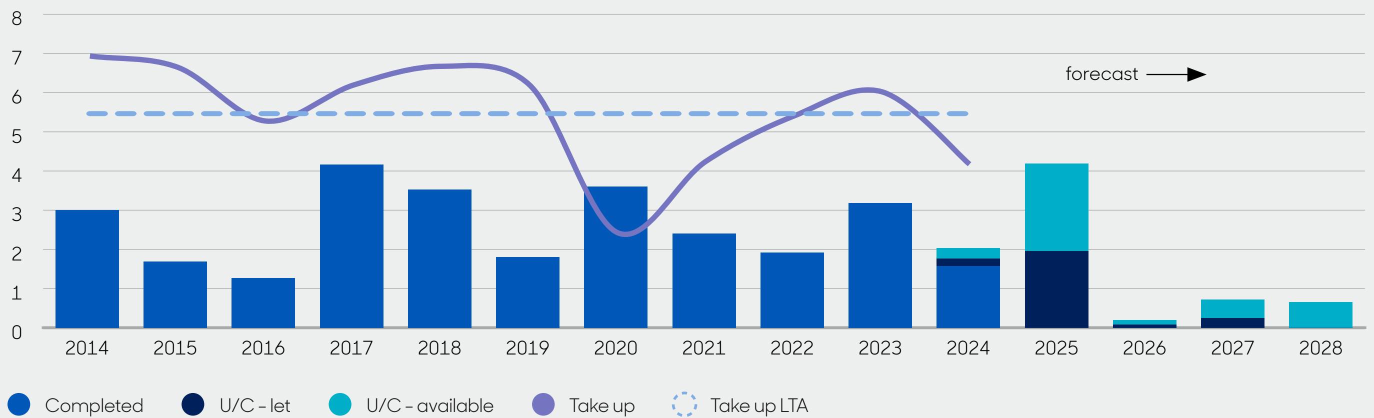
Case study: City of London

Prime rental growth in the City of London has outperformed the market at 3.2% annualised. However, this submarket's dynamics differ from the West End. The City has a more accommodating planning environment and is experienced in delivering large-scale tower blocks. As such, it's generally more debt (and rate) sensitive than the West End. While upper floors command top rents, the volume of space often leads to subdued rental growth and increased concessions. This widens the gap between prime and average rents, which have actually fallen around 1% over the past year. The 4.2 million square feet due for completion in 2025 would be the highest annual volume on record, followed by a sharp drop-off in 2026 (see chart 11).

With a growing preference for high-quality space, and fewer appropriate floorplates, pre-lets are increasingly common and they are being signed earlier. This is evidenced by 40% of incoming space currently being pre-leased. Additionally, tenant-controlled 'grey' space is not being subleased at the same rate seen in prior cycles, given the structural changes in occupier demand.

Active demand analysis by Knight Frank Research[25] suggests there is 20 million square feet of demand expected to derive directly from lease expiries in central London. While some occupiers will renew, downsize, or take on flexible space, the weight of this expected volume against a dwindling construction pipeline underscores the importance of delivering the right space to capture this demand.

Chart 11: City of London development pipeline



Source: Deloitte Office Crane Survey Winter 2024, JLL, Aberdeen Investments 2024.

[25] Insight 5: London's Future Demand Profile.

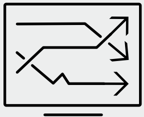
Development

To explore the different opportunities between the City and West end submarkets, we can make use of a basic model to solve for rental growth needed (in the West End) and yield compression required (in the City), given we are forecasting these to be the respective primary drivers of value for value-add opportunities. Note these examples, which consider rent free periods and incentives, are purely hypothetical and do not constitute investment advice.

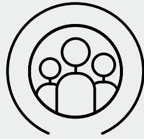
Development

West End

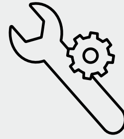
Assumptions:



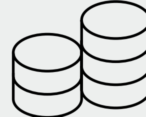
01
Current market rent for average space: **£75** per square foot



02
Vacant possession capital value: **£769** per square foot



03
Construction costs: **£450** per square foot*



04
Required profit margin: **18%**

05
Exit yield: **5.25%**

2 + 3 + 4 / 5 =

Rental growth premium over market rent required for return: **40.05%**

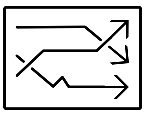
New rental tone required: **£105** per square foot

Yield-on-Cost required: **7.69%**

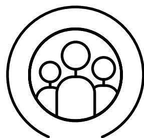
*Higher construction costs given older building stock, embodied carbon capture requirements.

City of London

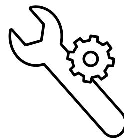
Assumptions:



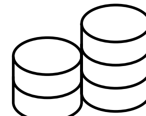
01
Current market rent: **£55** per square foot



02
Vacant possession capital value: **£410** per square foot



03
Construction costs: **£400** per square foot



04
Profit margin: **18%**

05
Rent on BREEAM Excellent space: **£85** per square foot

2 + 3 + 4 / 5 =

Prime yield compression required for return: **22bps**

Exit yield: **5.53%**

Yield-on-Cost required: **7.45%**

Even in weaker macroeconomic scenarios, the opportunities seen in the office sector remain robust due to the acute shortage of appropriate space. The increased pace of obsolescence, driven by ESG regulations, combined with the sizeable and demanding active requirements from occupiers, means that market equilibrium could be approaching more quickly than we expect. For well-located FACTS-compliant offices, the potential could be significantly understated.

Core strategies must consider incorporating these future-fit offices into their portfolios today, as the scarcity of such offices will be most apparent over the next five years. We see this as an attractive entry point for equity buyers who are equipped to take on development risk.

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STA1224148296-001