Market Insight

UK OFFICES

EXPLORING REAL ESTATE OPPORTUNITIES

In June 2024 ASK hosted a roundtable discussion forum for key players in the UK office market, including developers, operators, investors, funders and valuers in both the conventional and flexible office sectors. The group debated the current macro landscape, opportunities and impacts on the sector and also its expected future.

THE MACRO LANDSCAPE

Macro landscape

Currently the unloved asset class, the group agreed that the market has been negatively impacted by adverse publicity from the US. However, this has been offset by out-performance of best-in-class assets. The London market has repriced very quickly making it look good value compared to Europe. All agreed that the end of last year was definitely the bottom of the market and it has picked up in the last 3 months. It was said that the occupational market has seen a fear of missing out. Occupiers are now starting to look for space three or four years ahead of their lease event; this used to be one or two years. In the investment market, fear of going first has been seen with no one wanting to overpay if pricing has not yet reached the bottom.

"We hit the bottom of the market at the end of last year"

London market statistics

Take up last year in London was said to have been 9.5 million sq. ft. which is down on the 10-15-year average. However, grade A was 70% of the total leasing volume, with the 10-year average being 58%. Of the 3 million sq. ft currently under offer, 85% is grade A, demonstrating a real focus on best in class. Yet, there is 28 million sq. ft. available in London; the highest in 20 years and 68% above the 10-year average. The availability of Grade A space in the country is currently 9.5% but only 5% in London and rents usually rise when availability is at 5 or 6%.

All agreed that the shortage of grade A space is driving activity and there is a huge polarisation between super prime and the general market.

London sub-markets

Availability in east London, including Whitechapel and Canary Wharf was said to be at 17%. In the West End, some of the sub-markets were said to have less than 2% availability of grade A stock.

Occupier demand

The active demand from lack of stock means super prime rents are very strong. Someone commented that agents were often hung up on £ per sq. ft. but they had clients for whom rent was not a huge proportion of their outgoings who were happy to pay more to retain staff and avoid recruitment fees.

Given the market polarisation, one company now runs two sets of rental growth forecasts, for premium and the rest of the market. Premium was classified as BREEAM outstanding, EPC A with strong amenities and prime location. Their average prime rents are £80, but the top 10% of the average is £100. In the West End, the average is £140 with the top 10% over £160. Grade A super-prime yields in London are 3.5% with the rest of the market at 7-8%.

"There is capital at the right price which is fuelling optimism."

c.65,000 sq. ft of Grade A BREEAM excellent standard office space in Borough, co-financed by ASK and OakNorth Bank

INVESTMENT MARKET

In London last year transactions amounted to £7.5 billion, this was said to be 42% down on the previous year. In Q1 last year, only £1 billion was completed, compared to £5 billion in Q1 2022. The current year to date figure is £2 billion with one notable deal signed by Blackstone for over £200 million. Some felt there was currently a lack of liquidity for larger lot sizes and there was not much for sale that people want to buy. We are seeing premium pricing for ESG assets, much stronger pricing when buyers are very motivated and a few deals off market.

There was said to be greater liquidity in the debt market with deals coming through. Today's pricing however, is not very tempting unless you're holding particularly strong assets and there is a much bigger discussion around making the maths work for new buildings to be built.

How well is the market doing?

For the right product the market is actually going well. An example was given of the woeful volumes of around 400 million sq. ft. in the south east which received nearly £1.6 billion of bids. All agreed that the capital is there at the right price which is fuelling some optimism.

Who are the current buyers?

Many were finding that real estate high net worth family buyers who haven't bought since 2010 were coming back now looking for a deal at the bottom of the market. Institutional buyers such as pension funds were core buyers but are now selling off regional portfolios. The UK DB pension market owned about 6% of the regional office market.

One company very specifically said it focused on constructing leases to suit institutional buyers. It said that green lease clauses are as important as the internal fit out. London can rely on private money and other pools of capital but it's not the same in the regions. The first thing a buyer will look at is the ability to manage the asset easily.

REGIONAL MARKETS

Statistics

Using Addison Young big 9 figures, an overview was given of the regional market. 7.5 million sq. ft. of transactions were completed last year. This was said to be 20% down on the 10-year average. Sentiment was said to have been very weak last year due to political and economic instability. Q1 this year in the regional marketplace was 3% down on the 10-year average. In 2023 regional transactions were 7-8% of total deals in the UK. But in Q1 this figure was back to 30%. This was attributed to finance and professional services companies making moves, starting to better understand their requirements and putting ESG policies into action.

Occupation

Triggers and drivers were discussed. Triggers 20 years ago were lease events which are now much more regular with shorter lease periods.

Drivers used to be M&A growth, but now are ESG and overall betterment. By putting those factors alongside changes in corporate policy, this has become the basis for the flight to quality.

Availability in London was said to be at 9.5%. In Manchester it's 9.1% and other cities are below 8%. The inflection point was said to be 7%. Yields on development appraisals in the regions are starting at 6.5%. However, development has stopped which will lead to major shortage in 12 to 18 months time. The EQ development in Bristol, a back-to-frame refurbishment, is quoting at 6.35%. All agreed it would be interesting to see what percentage is achieved as it will be a bellwether for the market.

Some were more bullish on current yields, underwriting based on creating best in class in the right markets. They have seen occupation driven by the fitted space in the regions. This was not serviced space but Cat B, plug and play. Those more active in the core plus market are seeing stronger yields.

Can the regions sustain cost increases?

All agreed that one difficulty with the regional market was cost inflation compared to the rental values the market can sustain. The rise in costs is the same across the North but rents in Leeds are double what they are in Sunderland for example. If rents are at £10 per sq. ft., will they become unsustainable or achieve 100% growth? Some thought they probably would sustain the increase but occupiers would be demanding a lot for it and questioned if it would be cost effective to deliver that.

"Drivers are now ESG and betterment."

A 11,016 sq ft NIA freehold Grade A office building located between King's Cross, Holborn and Farringdon, co-financed by ASK and OakNorth.

COST V. DEMAND

What are occupiers looking for?

Often standard decent stock, a mid-sector offering with decent amenities, minimum EPC B. One attendee shared that their office in Stockton had achieved 40% rent growth based on light-touch refurbishment.

Delegates agreed there were two ends of the spectrum, best in class and essentially defunct. But, there is a whole lot in between offering good minimum standards which normal businesses are renting. All felt it was key to try to offer the best product for the market in which it is located.

What has been the impact of inflation?
Many felt that the impact of inflation had not come to fruition yet. Some were being more cautious on yields with interest rates likely to be cut soon. It was debated that the big push in rents because of scarcity, the importance for staff retention and because costs to employers have gone down as a proportion of outgoings, that the true effects were being masked. Prime, core Mayfair, is the only place where people were said to be looking for vacant possession. Elsewhere everyone is managing up to vacant possession.

Can you still make a return?
US investors were said to be questioning investment in UK offices, preferring the S&P or gold mining. There was still interest in characterful and iconic buildings particularly from family offices.

In core West End there's a lot of liquidity with everyone focused on a very small area. London zone 1 has 13 submarkets, but one company now only invests in 4 for fear of not getting a buyer in 4-5 years' time. Peripheral markets were considered risky, even peripheral West End.

In the 2014/2015 market if you bought well, you could lever it up and make a decent return. Going forward it will all be about nitty gritty asset management. Good stock selection and a very strong focus on yield on cost.

"There is still interest in owning iconic characterful assets."

FLEXIBLE OFFICE MARKET

How has the flexible office market changed in recent years?
Flexible offices started out as an impersonal, temporary offering for small businesses, sometimes used by large corporates for a project team.

When the dotcom bubble burst prices were £500 per desk; a similar price to today. However, allocations then were 75 sq. ft. per desk.

In 2008/9 the Starbucks coffee culture prompted operators to start offering amenities the space in buildings dedicated to office went from 80% to 70%; some buildings are now sub 60%. Desk sizes suffered as a consequence and went from 75 sq. ft. to 30 sq. ft. Some are now 25 sq. ft. which is the absolute maximum density.

The average occupier took 5 desks in 2000, 10/11 desks in 2010, 18 desks in 2017, and 20 desks before the pandemic. This growth was purely driven by the enterprise market who recognised the benefits of flexible space. It became a viable solution for over 30 - 40 desks. The average size of company in flexible space is now reducing as bigger companies are going back to conventional space.

The conventional market has responded to demand with offerings of 3000 - 5000 sq. ft. Cat A on 3 year terms with some extras included. The biggest single shift in the flexible office market was said to be enterprise demand.

What does the future look like?
All agreed that the way the new generation of workers wants to use office space is very different to today. Employees certainly hold the power now not the boss. However, it will be quality over quantity.

There is currently a bit of a supply demand issue the same as in the conventional market, encouraging a focus on existing assets.

One delegate shared that as London has become so expensive there is likely to be a market for office space with no amenities, no staff, aimed at smaller companies who want to be in a central location but want basic, low cost, functional space and are happy to go out for coffee and to the gym. They felt that there is a way to underwrite buildings so that occupiers can come in at an entry level, similar to Work Space but without any lounges. This could also be priced at all ends of the market. They also proposed putting more money into the office spaces. Coffee for example was said to be a lost leader anyway. This model was compared to the evolution of the hotel market.

Another provider agreed that larger office spaces had become competitive with conventional operators and said they had downsized to avoid competing with the landlord market. However, they felt the sub-30 space was buoyant. All their marketing is now selling to the team not the boss.

Is flexible space a solution for smaller buildings?

There are a lot of 20 - 30,000 sq. ft. office spaces on the market which investors are too afraid of running as conventional office space. It was asked whether they could work as flexible space. Obviously smaller buildings can't offer as much amenity space but it was said that the floor plate is key, with rooms on the outside. Some areas of London were said to be saturated. One person commented that there is currently no margin in the desk rates in Shoreditch.

Flexible operators present had buildings on a variety of freeholds, leaseholds and management agreements. Management agreements could be problematic, working with an operator with an established track record of delivering above conventional rents was advised and working to a sensible desk and lease rate. It was also put forward that flexible office space as part of a bigger building can work to create an ecosystem which maybe more appealing than all flexible space.

MARKET PREDICTIONS

What are we expecting in 12-24 months?

The occupational market was said to not be performing well. Lots of big occupiers have been holding off on decision making, re-gearing their assets and this will ultimately come to an end soon.

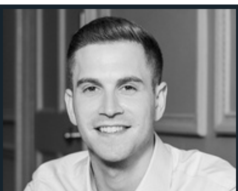
All agreed that we have hit the bottom of the market but maybe not on land. All thought now was the time to be patient.

One delegate felt that risk needed to be repriced to encourage activity in the market. At the very top end rental growth is driving value enhancement rather than contraction of yields. There is a lot of distressed situations stored up. Some buildings have halved in value in the last couple of years. Refinancing will be painful, but prime assets will be fine.

The new Google building opening in King's Cross this year was discussed as having the ability to make a huge impact on the market particularly by determining behaviour of staff and setting a precedent for office working. Many said that buildings were empty on Mondays and Fridays. The space is still being paid for but it is ultimately valued differently.

A recent report was cited, which says that 'bums on seats' in terms of office workers was now higher in London than pre-pandemic. London is the 3rd highest in the world behind China and Singapore in terms of working in the office. The US is in the lowest quarter.

"The conventional office space has taken the larger flex deals."



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