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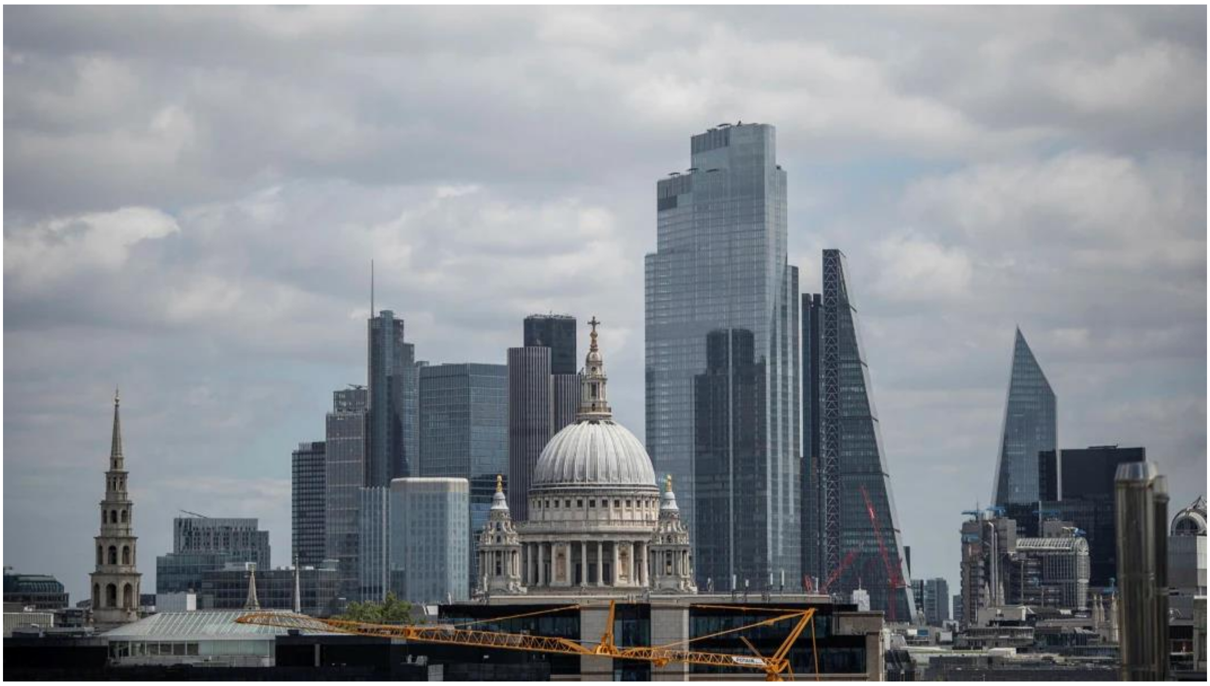
The Big Read   Commercial property

The property developers still betting on London offices

The market is splitting in two, between modern, flexible spaces and older buildings whose value is likely to decline



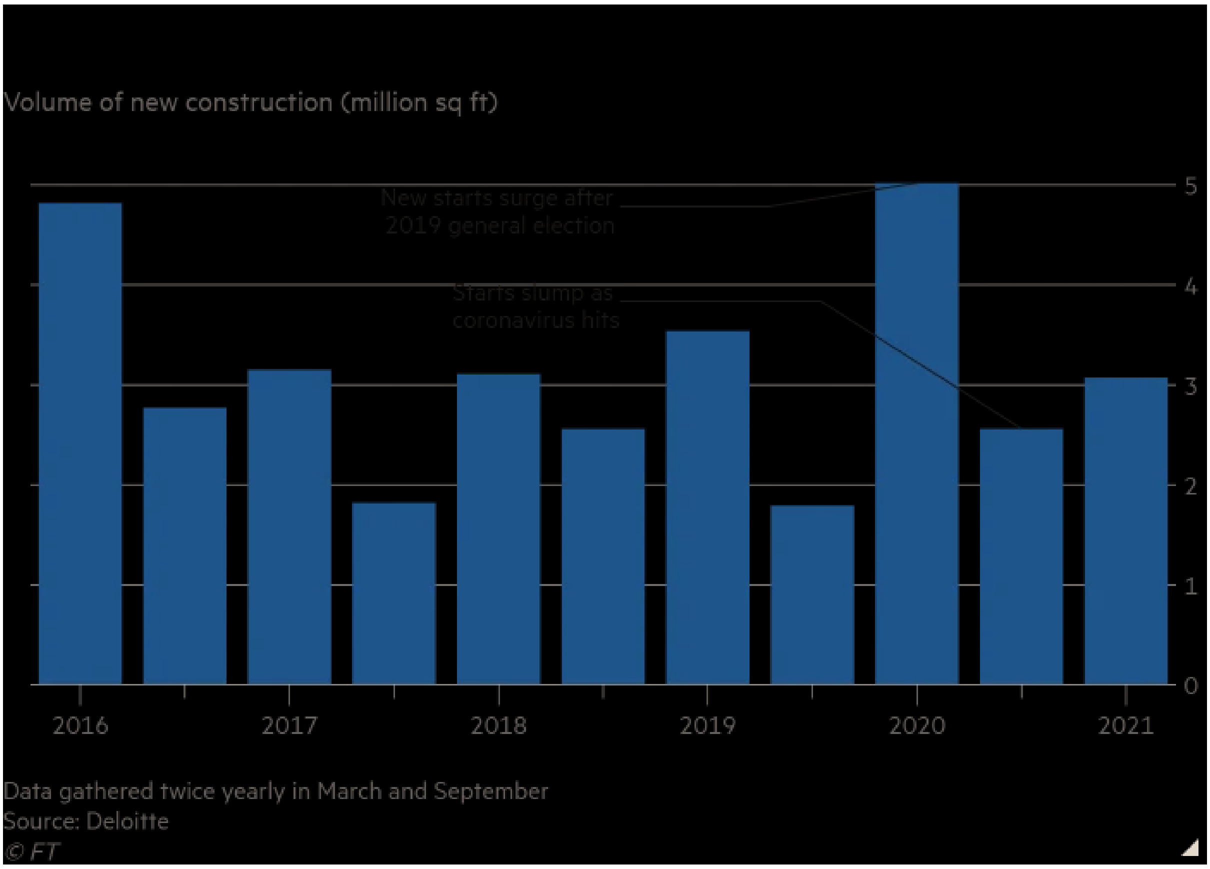
Just beyond the northern frontier of the City of London, a nondescript plot of development land is the subject of a fierce bidding war.

The site's price has soared in recent weeks on the back of offers from some of the world's biggest developers and investors. Each of them is confident they can turn a profit by making a bet on the future of London offices.

The one-acre plot in the Shoreditch district, owned by the London Stock Exchange, has attracted interest from the Canary Wharf Group, US investor Tishman Speyer and developer Helical; bids have spiralled from around £120m to more than £150m, according to people with knowledge of the sale.

To anyone who has recently visited the centre of London, this bullishness may seem inexplicable.

London office construction rebounds from COVID downturn



Many office buildings are empty at the moment and the consensus, even among those who make a living building or selling workplaces, is that they will be much less busy once the pandemic is over than they were before. Within the industry, there is a common estimate that London offices will have around 10 per cent fewer people in them on a daily basis.

A number of major employers, ranging from banks to technology firms, have rolled out flexible working arrangements and signalled their intention to ditch space.

Simultaneously, the growing importance of reducing carbon emissions looks likely to make a vast chunk of London offices obsolete in short order, triggering huge value destruction in pockets of the market.

And yet investors stand ready to pour as much as £45bn into the London office market once pandemic restrictions fall away, according to property agency CBRE. The few office sales which have gone through have done so at or close to pre-pandemic prices, yields have held firm and London’s leading developers say sellers of distressed properties are hard to find.

Within the industry, there is a common estimate that London offices will have around 10 per cent fewer people on a daily basis © Simon Dawson/Bloomberg

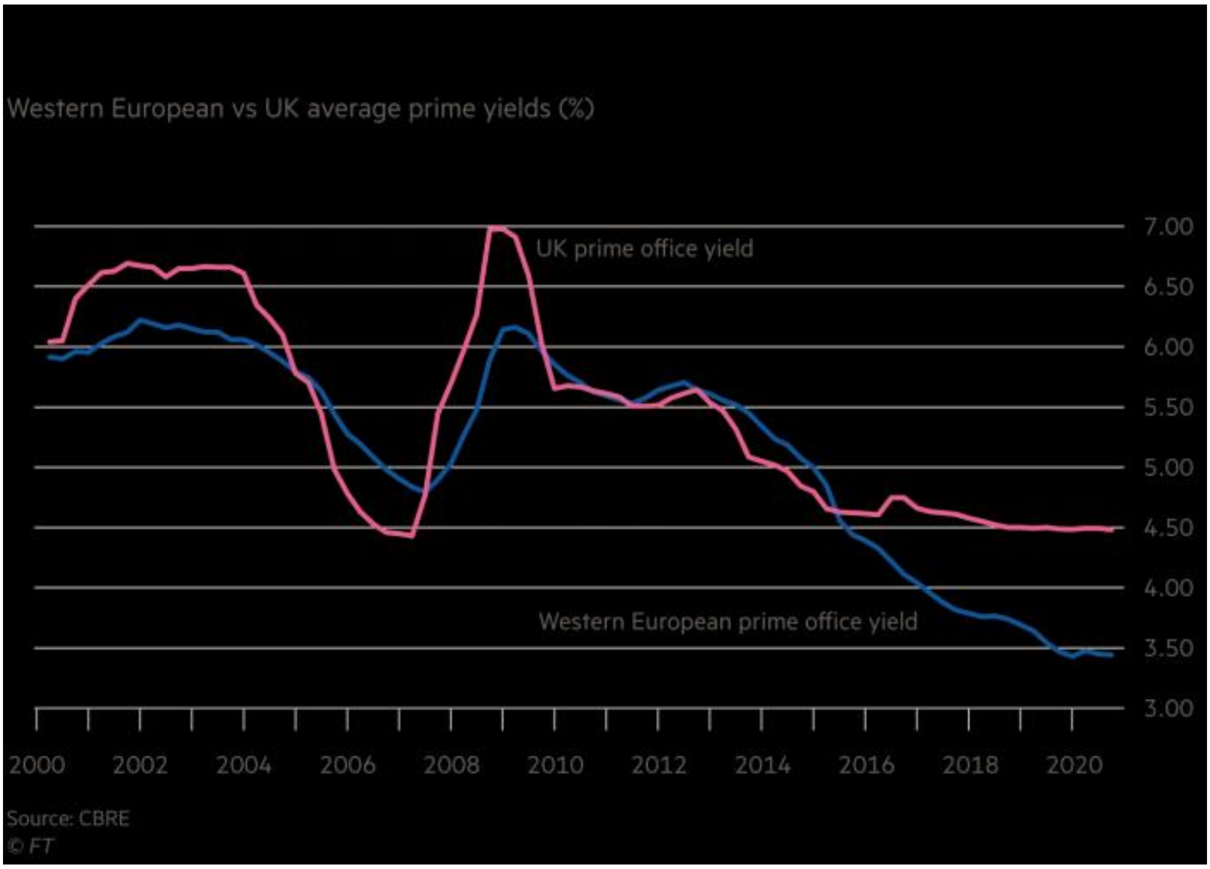
What exactly is going on? In dozens of interviews with property executives, investors and analysts, one explanation comes up repeatedly: coronavirus will cleave the office market in two.

“There will be a clear bifurcation: anything that is flexible, modern and has access to open air will be high in demand and rents will be resilient there, but in the secondary market there will be accelerated obsolescence,” says Mark Allan, chief executive of Landsec, a FTSE 100 developer with 60 buildings in London.

The former, they say, will command high rents from large corporations competing for talent — law firms and tech companies chief among them. The latter will empty out and have to be refitted or repurposed.

It is a line of argument which allows office developers to tout their own chances of success while acknowledging the broader malaise in the market.

UK office yields flatline thanks to BRIXIT



So far, high-end finishes and cavernous atriums have not inoculated offices against the collapse in demand for space. Expected sales values for central offices have fallen steadily since the start of the pandemic, slipping every quarter from the start of 2020 to the end of March this year, according to CBRE.

Investment in London offices remains way down on normal levels. In the first four months of the year, it was down by 53 per cent compared with the same period in 2020, according to Savills.

But there are signs of recovery as social distancing restrictions ease in the capital and, with them, evidence to support the theory that there will be winners as well as losers after coronavirus.

In the first three months of the year, the average rent agreed on new leases for high-quality offices in the City was £82.50 per square foot, up from £75 in the fourth quarter of 2020. The shift is down to a “heavy bias towards ‘grade A’ [offices] in the market,” says Mat Oakley, head of European commercial property research at Savills.

Property firm JLL has signed up to a 15-year lease on 134,000 sq ft at British Land's 1 Broadgate development © HayesDavidson

In recent weeks, property firm JLL has signed up to a 15-year lease on 134,000 sq ft at British Land's 1 Broadgate development and viral video app maker TikTok has agreed to lease the entirety of Helical's Kaleidoscope building in Farringdon, also for 15 years. After a rent-free period, TikTok will pay £86 per sq ft, according to people with knowledge of the deal.

"The big tenants have got to move," says David Camp, chief executive of Stanhope, a London developer whose projects include Bloomberg's London headquarters and the redevelopment of Paternoster Square by St Paul's Cathedral. Companies view new offices as a weapon in the war for talent, he says.

In a recent Knight Frank survey of almost 400 large employers who collectively employ around 10m people, 37 per cent of respondents said that property formed part of their strategy to attract staff. Half said that offices supported their corporate brand and image.

Sony Music, relocating from Kensington to King's Cross, told architectural practice MoreySmith that its new headquarters should be designed to attract and retain talent, according to Linda Morey-Burrows, principal director at the firm.

"People commute for more than an hour, they need a reason to come in. I know for sure that people don't want to come back to big Plexiglas and signs saying, 'Put your mask on'. They want to feel comfortable and to feel they're in an environment where they're getting more than they get at home," she says.

Linda Morey-Burrows, principal director at MoreySmith, says people want to 'feel they're in an environment where they're getting more than they get at home' © MoreySmith

Capital revival

Partly on that basis, developers and investors are betting that demand for new space will be sustained.

According to CBRE, global investors have earmarked between £40bn-45bn to invest directly into London offices, more than any other European city and the highest volume of cash since the agency started tracking investor intentions in 2012.

Investors are targeting "best-in-class" assets deemed to be most resilient, a typical practice in the aftermath of financial shocks, says Stephen Down, head of central London investment at Savills. "At this phase in the cycle, when you come out from under the rock, you have got to go where the banks are willing to lend. That's on the very best [properties]," he says. That means new, spacious, well-equipped and green.

"Investors are active once again [after] a prolonged period of muted activity," says James Beckham, head of central London investment at CBRE. A growing number of deals are taking place behind closed doors, without the properties being advertised, he adds.

Last December, Singaporean investor Sun Venture agreed to buy Landsec's office development at 1 & 2 New Ludgate for £552m — more than the £546m it was valued at in March 2020 © Anna Gordon/FT

In December last year, Singaporean investor Sun Venture agreed to buy Landsec's office development at 1 & 2 New Ludgate in the City of London for £552m — more than the £546m it was valued at in March 2020. According to a person with knowledge of the sale, the buyers did not visit the site before agreeing to the purchase.

Ronald Dickerman, president of Madison International Realty, a private equity firm with holdings in West End landlord Capco and a stake in Paternoster Square, is likely to join the scrum for London offices. He says the UK capital is emerging from the "double cloud" of Brexit and coronavirus under which it has now toiled for five years.

As London grappled with Brexit, investors turned to other European cities. The result has been a divergence in yields — an indicator of expected annual returns on investment which drives commercial property strategies — between London and other western European cities.

The average yield on the best stock in central London is 4.2 per cent, compared with less than 3.5 per cent in European cities monitored by CBRE. In Paris, average yields are at 2.75 per cent and trending down, according to the agent.

London, which entered the pandemic with office vacancy rates near record lows, now looks better value than its rivals, says Dickerman.

"With the onset of summer, warmer weather and people outdoors, there's a reawakening. There's pent-up demand for inward investment flows, [and] for office take-up in London. Five years ago people were thinking about Frankfurt and Dublin and were skittish about London. I see a recovery and a recovery trade that should be made now," he says.

The speed of the UK's vaccine rollout is another crucial draw for investors in London, the vast majority of which are from overseas. "It's pretty much the only factor driving investors at the moment," says Savills' Oakley. "If every adult will be vaccinated by June, the prospect for a strong recovery is high."

David Camp, CEO of Stanhope, a London developer whose projects include Bloomberg's London headquarters pictured, says 'the big tenants have got to move' © Nigel Young

Concern for older stock

But elsewhere in the market, signs of life are harder to find. More than 3m sq ft of office space, much of it small lots in older buildings, has flooded on to the sublet market during the course of the pandemic, according to Savills. This so-called "grey space" shows no sign of being hoovered up by new tenants despite the prospect of discount rents.

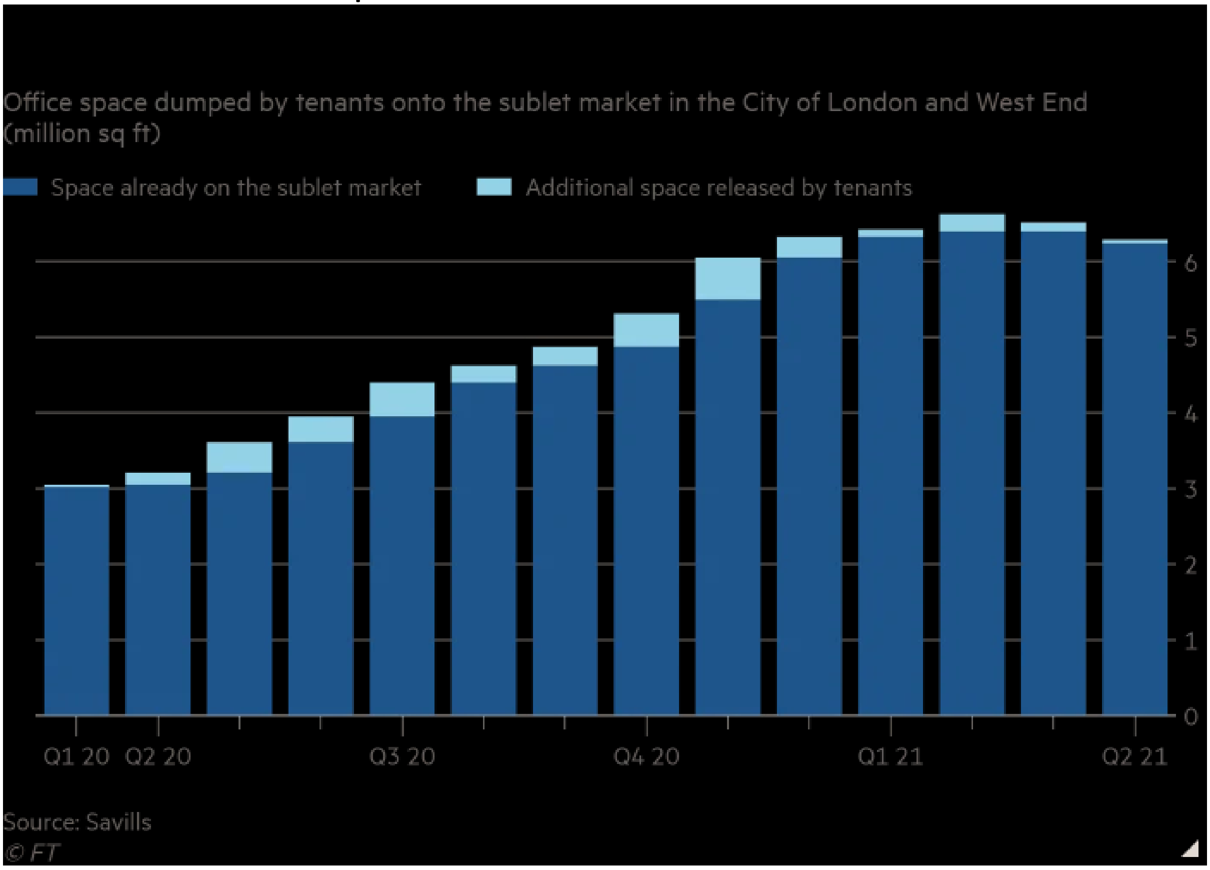
Vacancy rates in the City of London edged up to 8.9 per cent at the end of March from 5.3 per cent a year earlier, according to Savills. "We will get very close to 10 per cent [vacancy] in the City market this year," says Oakley.

But he expects it to be overwhelmingly older offices which empty out, leaving the largest developers such as Landsec and British Land relatively unscathed.

"Institutional landlords will have the breadth of portfolios and access to liquidity needed to ride out the storm. Smaller independent landlords will not have that kind of firepower to cope with the loss of income or value in the same way," says Alastair Carmichael, investment director at property investor HB Titan.

Carmichael cautions that a slew of non-performing loans tied to offices might emerge as a result.

Tenants rush to ditch office space



Sustainability push

That trend could accelerate as owners of older offices, already buckling in the face of the pandemic, see their problems compounded by the growing urgency of the climate crisis.

The financial crisis left property developers and investors in a scramble for survival and diverted them from climate commitments. So far, coronavirus has not had the same effect, in part because debt levels across the sector are far lower than in 2008 and speculative development has been more contained.

Many of the world's largest property owners, investors and tenants have rolled out or beefed up environmental commitments during the pandemic. British Land has set a target of achieving "net zero" carbon emissions by 2030. Sustainability has risen to the top of the list of tenant demands, slicing the market in two "like a knife", says Simon Carter, the company's chief executive.

"Eighteen months ago, one or two [tenants] might have had sustainability somewhere in their list of requirements. Now it's everyone, right at the top: 'We would like a net zero building'," he says. With the built environment responsible for roughly 40 per cent of the UK's carbon footprint, the potential prize — and cost — is huge.

Bids for a one-acre plot in Shoreditch, owned by the London Stock Exchange (pictured), are said to have spiralled from about £120m to more than £150m © Simon Dawson/Bloomberg

Those commitments will see financing flow to new net zero projects which aim to reduce the energy associated with building and running an office, for instance by generating the energy used on site from renewable sources, using sustainable materials and shortening supply chains. For now, though, many developers also rely on carbon offsetting to push down the net emissions associated with construction, a practice which has been criticised by activists as a get-out-of-jail-free card.

Yet the push to net zero will narrow the set of offices which can be built, bought or occupied, leaving a long tail of stock which does not meet new standards and risk falling into obsolescence.

“Is there potential for value destruction? Definitely,” says Stanhope’s Camp.

He predicts that a rent gap will rapidly open up between offices with low emissions and those without.

London is the world leader when it comes to low carbon office development, with close to 3,000 green-certified buildings, according to Knight Frank. But that is nowhere near enough to meet emerging demand for net zero space. The agency estimates that 40 per cent of all the capital targeting the London office market this year is focused on green-certified offices.

More than a means to command higher rents, strong sustainability credentials may ultimately be the key to survival. The phrase “stranded assets” — commonly used to describe fossil fuels which have to stay in the ground if carbon targets are to be met and therefore risk becoming worthless — is now cropping up in property circles.

Nathalie Palladitcheff, chief executive of Canadian property investor Ivanhoé Cambridge, owner of around 1,000 properties including multiple offices in London, says the shift could be as dramatic as the electrification of workplaces.

“It used to be a plus. Now, can you imagine working in a building without electricity? Without all these new [sustainability] criteria your building is nothing,” she says. Ivanhoé Cambridge has committed to make all new developments net zero by 2025.

London is the world leader when it comes to low carbon office development. Demolition of the former UGLI office building in White City was part of a redevelopment © Kevin J. Frost/Alamy

Bringing buildings up to carbon neutral standards will not be cheap, however.

“The serious cost will be where you’re looking to get to net zero on an existing estate, not on new development. The investment across the sector runs to many, many billions. That isn’t really being talked about,” says Allan at Landsec, which is now tying its incentive plans to net zero targets.

Ultimately, if offices can’t be retrofitted to lower emissions, rents could fall to a point at which they become redundant. Any property more than 20 years old, with low floor to ceiling heights and small windows, will be hard to repurpose into alternative uses such as homes and will be most at-risk, says Camp. That raises the prospect of moribund properties littering high streets, local authorities losing out on tax revenue and pension fund investors taking a hit.

Perversely, the obsolescence of offices with poor environmental credentials could also mean more carbon is emitted in places like the City of London. Companies with net zero targets demand offices which emit little, and the cheapest way to create those is through new development. But that means gutting or tearing down existing buildings, an enormously wasteful process given the total carbon outlay involved in developing the original property.

The environmental agenda is “still full of contradictions which need to be worked through”, says Allan, who compares the decisions consumers make about whether to trade in their petrol powered cars to those of businesses scouting for new offices.

“Using a car to the end of its life is better than buying an electric vehicle to make yourself feel better,” he says.

These risks have not killed activity. But the prospect of value destruction in parts of the market, low occupancy in others and uncertainty over how we will use office space in future will all weigh heavily on the minds of investors preparing fresh outlays in London.