

# LONDON OFFICE DEVELOPMENT PIPELINE: THE CHALLENGE AHEAD



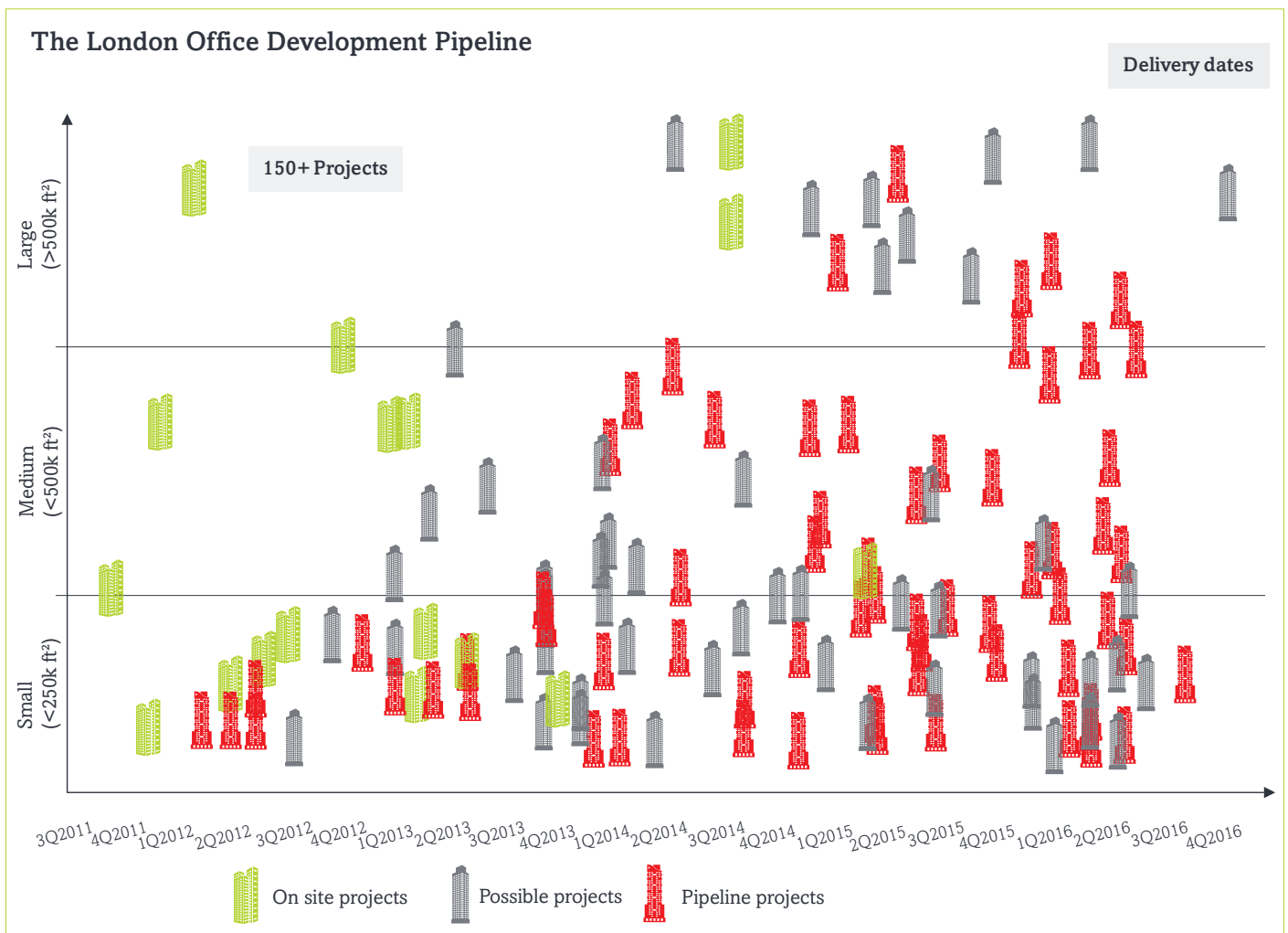
EC HARRIS  
BUILT ASSET  
CONSULTANCY

**Executive summary:**

- The London office pipeline equates to a construction value of £12 billion over the next 4-5 years
- The City of London represents over 60% of the London office pipeline
- New development dominates the pipeline with relatively little refurbishment planned
- Funding will follow tenants therefore 'tenant focused' developments will be the winners.

The London office development pipeline is significant and growing. There are currently 150+ projects with the potential to deliver over 53 million sq ft of floor space by 2016, but, not all will be delivered. Tenants are becoming rarer and much more cautious about committing to new space. So what space will tenants be choosing? Developers will need to ensure that their development pipeline is aligned to the future tenants needs if they are to beat the market.

The London office pipeline shows that a total construction value in excess of £12 billion could be expended over the next 4-5 years.



The London office development market is not immune to the Euro crisis. Diminishing tenant optimism and tighter funding markets have made it more difficult to launch projects via the traditional development route of debt-funded pre-let. Alongside this, decisions by some occupiers to opt for a lease extension or relocation into an existing building means that hopes for a wave of redevelopment driven by lease renewal could be unfounded. Together these present a significant challenge for developers to secure tenants and start development.

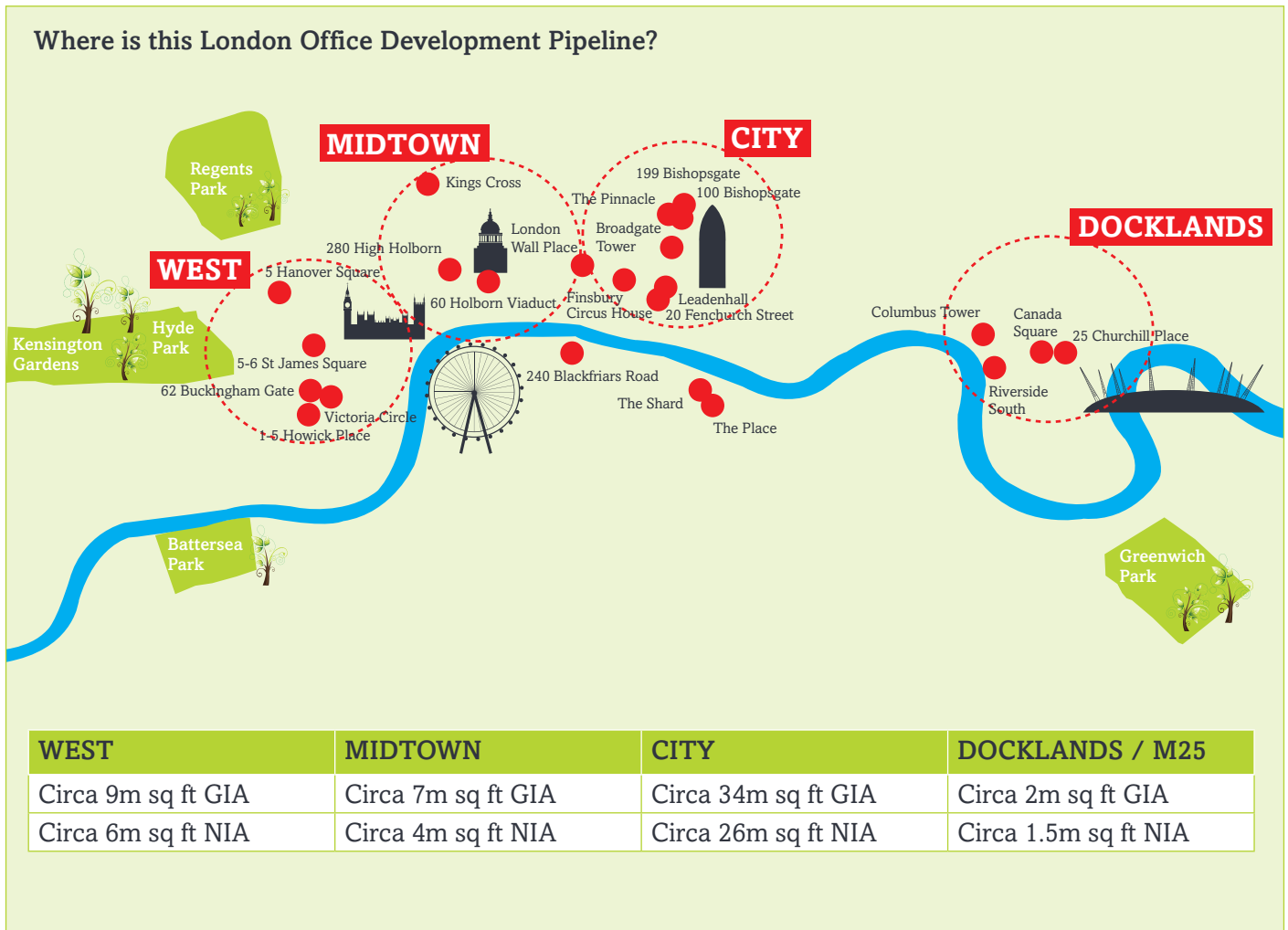
We have examined the size and location of the current London office development pipeline, covering projects currently on site, with planning permission or in design. The majority of these projects will not be delivered to site before the 2016 threshold date and in some cases, they will never reach site at all. Nonetheless, our research shows that there is a 'real' pipeline (on paper) of circa 37m square foot of net floor space, representing nearly 4 years of total take-up based on the long-term Central London average of 10 million net square foot per annum.

### What has driven such a significant pipeline?

The growth of this pipeline has been directly driven by the volume of lease renewals representing 25-70 million square ft of office space estimated to expire before 2017. In reality large high rise developments that need a significant pre-let to support the conventional debt funded development model may be left waiting, as tenants extend their existing leases or choose to take more tenant flexible space. In addition some tenants may consider moving their business to alternative locations within London.

The pipeline suggests that a large proportion of future projects will be relatively small, and as a result, potentially easier to fund and deliver, if pre-lets can be achieved. 50% of projects currently in the pipeline are under 250,000 square foot gross, and fewer than 30% are over 500,000 square foot gross.

Our research confirms that the City has been the centre of attention for developers and investors alike and represents over 60% of the total area (34m square foot gross / 26m



square foot net) and over 50% of the projects on the pipeline through to 2016. The average size of a project in the City is circa 420,000 square foot gross, nearly twice the size of those planned for the West End or Midtown, reflecting the large scale tower schemes planned or presently under construction such as, The Leadenhall Building, 100 Bishopsgate and 20 Fenchurch Street. The size of these projects present a significant challenge to achieve the minimum pre-let threshold required to trigger funding and construction activity. Therefore the opportunity exists for ‘smaller’ projects where speed of delivery is more assured.

Midtown is characterised by smaller projects and potentially over 30 developments totalling 7 million square foot gross, with an average gross area of 210,000 square foot (150,000 square foot net).

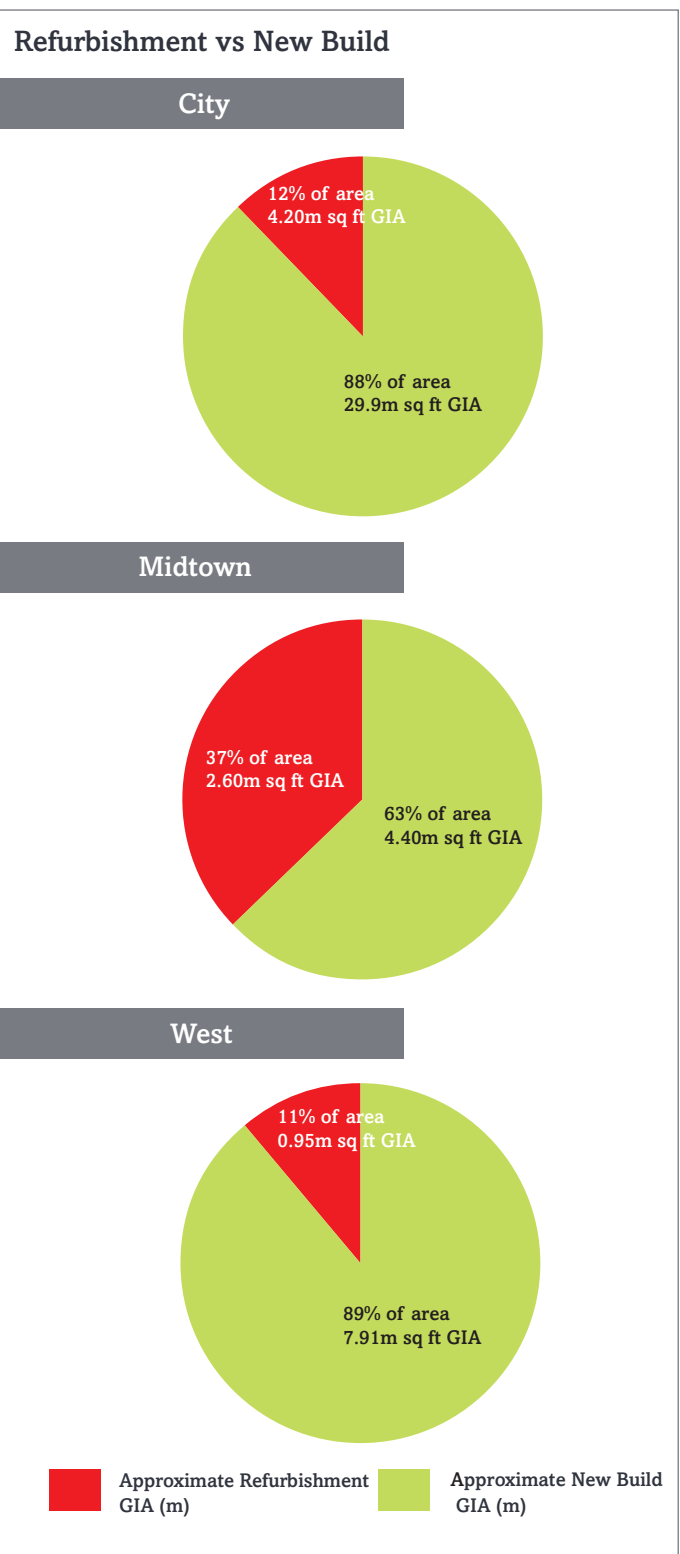
By comparison, the West End pipeline is relatively constrained and reflects the greater planning challenges experienced in Westminster, supply constraint and a more diverse tenant profile. Nevertheless, 9 million square foot gross of new and refurbished space is included within the pipeline, comprising of 25 developments that could commence pre-construction or start on site over the next 4-5 years. The average development size is 240,000 square foot gross (170,000 square foot net).

**Refurbishment - An Increasing Opportunity?**

Pre-let agreements do not offer a ‘client-focused’ solution, unless the terms product and location, or a combination of all three, are extremely attractive to a potential tenant.

Tenants are under pressure to reduce their cost of occupation, therefore there has to be an extremely strong business case for a tenant to make such a major commitment to relocate. There is a very real prospect that the lease-break driven redevelopment cycle could fall away very quickly. However from crisis comes opportunity for those developers / asset owners who are in a position to deliver quickly, particularly within the refurbishment office market. Market uncertainty is driving a risk adverse and cautious approach from tenants. Relocating is disruptive, making the ‘stay and refurbish’ option very attractive and this suggests an increase in refurbishment and re-fit works. Flexibility and speed of delivery will be the key factors in determining if a move to a new development is the preferred solution.

Given the market conditions there is a surprisingly low level of refurbishment space planned or in construction. Only 15% by area is refurbishment space, with Midtown holding the largest proportional pipeline at over 2.5m square foot gross (37% of the overall Midtown pipeline). Only 12% of the pipeline space in the City is identified as refurbishment.



This presents asset owners with a new opportunity. The frantic and competitive London investment activity around existing office assets would support this as landlords look to work with existing tenants to develop a low-risk solution based on lease extensions.

## What factors affect the pipeline?

The pipeline appears strong and investment remains very active. The underlying drivers of the pipeline are:

### Lease Expiry

Lease events have driven developer optimism since the dark days of 2009 and 2010. Lease expiries will occur on office space totalling between 25 and 70 million square feet between now and 2015 in the City of London alone. Certainly a huge volume of ageing office space presents an opportunity over the next few years, but what this space represents in terms of new build, refurbishment or even redevelopment as residential is increasingly uncertain. Trends show that from 1988-1995 there was a peak of new build lettings, based on long leases of 20-25 years. These leases are expected to expire during 2013-2020. In anticipation of a surge of new tenants, the pipeline indicates that the majority of new projects are expected to land on-site from 2014-2015 onwards. Major project completions are expected to peak by 2015-16.

### Employment growth

In the short term, BFS employment growth is expected to be below par and therefore will hold back demand for a net increase in modern office space. Uncertainty over staffing levels is a major constraint on businesses committing to a pre-let and reinforces the importance of making space available for organisations when they have the need to relocate and the confidence to grow.

### Occupiers consolidate current space

Current trends show that across Western Europe, businesses are looking to consolidate or reduce their space as occupiers look to a combination of flexible working, increased occupation densities and reduced operating costs. This will impact demand for new space. We are presently working with market leading developers utilising target occupancy 1 per 7m<sup>2</sup> to differentiate their product (this exceeds the BCO specification of 1 per 8m<sup>2</sup>). Many asset owners are refurbishing existing buildings, particularly larger multi-tenanted buildings where landlords can deliver a substantial upgrade of an occupied building around key retained tenants, fast and with minimum disruption.

## Cyclical demand for office space

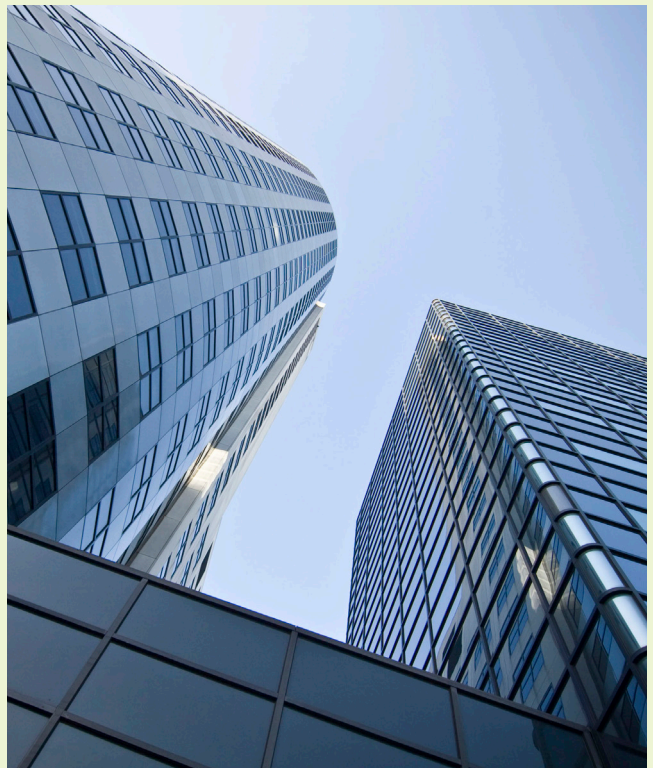
The Corporation of London's 2011 core strategy, envisages a long term decline in net office space creation, to 50,000m<sup>2</sup> per annum from 2016 onwards. As the pipeline shows, pipeline supply is outstripping tenant demand. Once the lease-break driven requirement in 2014-2016 has passed, it will be more difficult to convert proposals into projects.

### Investor refinancing during 2012

Finance continues to be a major constraint on new developments. A number of UK and European Banks have completely withdrawn from lending in property and a further £200 billion of loans will need to re-finance during 2012. The lack of conventional sources of finance, and tighter terms creates an opportunity for other players to participate as joint venture partners. However, the dilution of equity that results from these arrangements may affect returns and the ability to progress development.

### Competition from residential

Figures from the City of Westminster suggest that 2 million square foot of office space has been lost to residential over the last 5 years. This trend is set to increase, particularly in the West End and some areas of the City, as prime residential stock offers a robust and safe investment during these volatile times.



## How can developers and investors improve their chances for success?

The London office development market is set to be extremely competitive for some time to come and the decrease of potential tenants will fuel the need for market advantage. We have identified three key areas for developers and investors to focus on, to help improve the chances of success and drive real competitive advantage in relation to their developments:

### 1. End-user alignment

Schemes designed in the mid-late 2000's are typically 'Product Centric' focused more on appearance and conformance to industry performance standards and are now potentially unviable or unable to meet current tenant needs. We predict a shift towards 'Performance Centric' projects. This type of project is forward thinking and has the end-user in mind. They focus on non-institutional standards, offer flexibility and tenant focused design, are aligned to CSR strategies and reduce operating costs.

A performance centric approach means the developer / investor must understand the Business Case for tenants to take up new space in the future. The following areas need to be considered to ensure developments are better aligned to the end user.

**Financial alignment** - in the present market, the financial terms, the cash flow implications, lease periods and rent free period agreements become more critical than ever in terms of supporting the tenant's business case for an early commitment to re-locate.

**Flexibility** - the flexibility of office space in terms of ergonomics, access and the ability to efficiently expand / contract space requirements represents a key driver for potential new tenants.

**Product alignment** - the different end-user, be it media, legal, technology, property or financial, all require a desired specification, rental level, floor plan layout and location. In terms of competition and potential tenant targets, effective research can ensure that the base product is aligned to the tenant needs. We recommend developers and investors invest the time and money to address this in the design brief.

**Sustainable excellence** - in present times, one would assume that the importance of sustainability is no longer a priority. This is not the case. Tenants, investors and developers alike all see BREEAM 'excellent' or 'outstanding' building as a differentiator and it is a base requirement, creating long term value.

**Certainty of delivery** - tenants need speed and certainty of delivery to sign up to a pre-let. If projects require more than a single extensive pre-let for instance, the potential start date could be delayed as a second tenant is sought. Smaller projects that can be delivered quickly will have a competitive advantage.

**Reduced operation costs** - every business needs to reduce occupation and operation costs. We recently completed a whole life cost study for a global bank that identified a plan to achieve the 10% cost of occupation challenge across their global portfolio. How many developers can demonstrate how their building could meet this challenge or incorporate this in the design brief?

### 2. Funding alignment

Funders continue to demand certainty, be it appraisal, delivery, costs or tenant requirements to gain funding. Risk mitigation is paramount as potential funders seek to invest into assets with 'guaranteed' returns. Seven key issues need full consideration:

**Equity investment** - up to 40% to 50% of upfront investment is required and many developers are entering into JV's to spread the increased equity risk.

**A secure exit strategy (pre-lets)** - an exit strategy is needed to cover the amount of debt and interest roll-up, supported by a third party underwriting senior debt.

**Optimising value creation** - a clear client brief supported by experienced design and consultant teams, who are prepared to challenge the client, will ensure that the end product maximises the site value, balanced against the ability to lease and / or sell at the appropriate terms.

**Creating a long term sustainable asset** - an efficient, flexible and cost effective scheme is paramount. Investors look well beyond the short term initial pre-lets and seek to maximise the long term potential of an asset. Flexibility for future market driven change; be it long term tenant alignment, refurbishment potential, extension or possible change of use, are vital considerations within the due diligence that investors undertake.

**Developer certainty** - a strong balance sheet and a proven trade record in location provide the guarantee that the Banks and Funders require. This needs to be coupled with a strong appraisal, sensible contingency, profit margin, headline rent and yield.

**Cost certainty** - before developers and / or funders decide to commit to significant expenditure, confidence of costs in terms of out-turn construction and development is

an absolute pre-requisite. This is achieved by clear client briefing, consultant selection and no short cuts during the pre-construction process, aligned with a robust procurement strategy.

### 3. Act now!

With the pipeline set to increase and the potential emergence of refurbishment projects, the opportunity for new development is set to reduce. Be it refurbishment or new development for speculative developers and investors, speed to market is crucial. The ability for a scheme, to react to a tenant opportunity / market demand and reach site at the earliest feasible date, provides the developer with a clear market advantage. Commitment to early design, procurement, expenditure and ultimately confidence in the assets ability to perform in the market is required.

Without the financial backing of a funding partner, many developers are not prepared to speculatively spend monies on fees, site acquisition, marketing etc early in a projects life line. Ultimately, a realistic appraisal, with a sensible headline rent and yield with performance centric / flexible design will afford the greatest chance for success, of course backed by a sizeable pre-let.

### Methodology

The research was conducted in November 2011 and is based on a 'snapshot' analysis of commercial office development projects currently being planned for delivery in central London through to 2020. It uses an estimation of development programme, total unit numbers, independent reports in the public domain, saleable area and sales values to assess the total number and area expected to be delivered per annum in this market segment for the next 8 years. It is not an exhaustive analysis of all schemes in the public domain but illustrates the clear profile of the future development pipeline.

*“Be it refurbishment or new development for speculative developers and investors, speed to market is crucial. The ability for a scheme, to react to a tenant opportunity / market demand and reach site at the earliest feasible date, provides the developer with a clear market advantage.”*



For more information, please contact:



**Richard Taylor**

Partner, Head of Commercial Development

t +44 (0)20 7812 2628

e [richard.taylor@echarris.com](mailto:richard.taylor@echarris.com)

**[www.echarris.com/commercialdevelopment](http://www.echarris.com/commercialdevelopment)**