LONDON OFFICES LEAD THE WAY IN THE HUNT FOR UK RENTAL GROWTH

AS THE UK MARKET ENTERS ITS SECOND PHASE OF RECOVERY, THE HUNT FOR RENTAL GROWTH IS ON - AND CENTRAL LONDON OFFICES WILL LEAD THE WAY

By Patricia LeMarechal, SIOR, BSc (Hons), MRICS

Commercial property was booming in the U.K. in 2014. According to data from MSCI, all property total returns across the country averaged 18 percent. The performance of central London office property was even stronger, with both the City and West-End office markets recording returns of just less than 25 percent. The investment market bounced back strongly and there were significant levels of yield compression and capital value growth across all central London office markets.

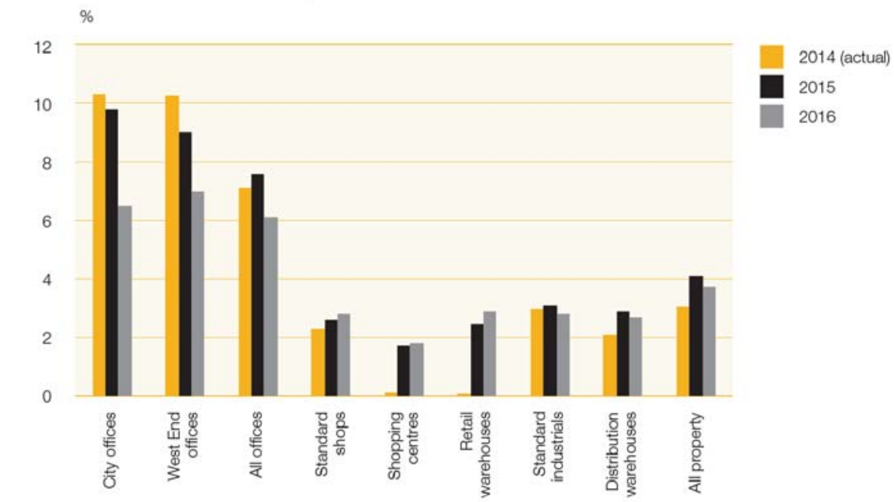
During this time, occupiers were feeling more confident in the strength of their own businesses, the economy was beginning to return to normality, and large amounts of capital were targeting the sector. Occupiers were making the decision to upgrade or occupy new office space in central London, and consequently, supply levels fell. Companies from a broad range of sectors were steadily absorbing the available space in central London's core office markets, from technology and media, to energy, and traditional banking, finance and insurance sectors. This took supply levels to record lows at a time when the development market was reticent to begin large scale construction projects.

As we reach the midpoint of 2015 and look ahead, the market has continued to grow and London's market is now entering the next phase of the cycle; we forecast total returns for all U.K. property in the low teens with reducing levels of capital value growth and an increasing reliance on income return and rental growth. Properties in central London—notably offices in core city and West End markets—are expected to post some of the strongest rental growth over the next few years. London continues to lead the pack into the next phase of the cycle.

The central London office market is now at the point where development is returning, demand levels are strong and availability is at very low levels. Given the relatively long lead time on development projects, availability is likely to remain at low levels until 2017, engendering a strong rental growth environment this year and next. Of course, much depends on the strength of occupier demand continuing throughout this period, and whilst there are always downside risks to this, the level of under offers and requirements in the market are strong and suggest it will continue. However, not all areas and types of office space are expected to perform equally.

Gerald Eve's latest research on central London offices can be used to help identify areas of strong demand, weak supply, and therefore, above average prospects for rental growth. Through analysing the core markets in the City and West-End on a floor-by-floor basis, rather than just by total volume, Gerald Eve has helped clients identify not just areas of potential interest, but also the building configurations which are in short supply and likely to experience above average levels of demand. Given yields are at or approaching record lows and competition for the best assets is fierce, and this has proved a useful tool in the hunt for rental growth across the capital.

Annual rental growth forecasts
Source: Gerald Eve Research, IPD



In the City for instance, availability, by both the number of floors and the overall volume of space marketed, has fallen sharply over the last two years. During the first quarter of 2015 there were only 374 floors (2.9 million sq. ft.) of floor space on the market in the core City postcodes. Supply fell due to strong levels of occupier interest in EC2, particularly due to the considerable number of small to medium sized floors which were put under offer during the first quarter. This almost halved the number of floors on the market between 10 to 20 thousand sq. ft. in size in the space of one quarter and made this sub-sector of particular interest.

It is a similar story in the West-End; demand for the best space is extremely strong and there is considerable upward pressure on prime headline rents. Average prime rents in the West-End currently stand at around £117.50 per sq. ft. ($180.64 USD), although exceptional deals on the best space are being agreed upon at much higher rates. There are markets, such as the office market in Victoria, which has very low levels of availability, but is one of the more popular locations listed in occupier requirements. Whilst there are developments underway to try to match this demand, with the Nova North and Nova South schemes and the Zig Zag building expected to help fill the supply gap, there is still considerable room for short-term rental growth in such a market.

As the U.K. commercial property market continues into the second phase of its recovery and becomes increasingly reliant on income return and rental growth, London is expected to lead the way. The medium term supply shortage will create increased levels of rental growth, but not all sub-markets are expected to be equal. Understanding the occupier market dynamics, which often vary from sub-market to sub-market, or even between building size categories, is crucial for those looking to identify the potential hotspots.

To find out more or to view Gerald Eve's latest central London research, visit www.geraldeve.com. ■

(All Things Considered, page 61 continued)

216,910-square-foot City Hall Plaza went for $19.75 million ($91.50 a foot) on a 6.97 percent cap rate; and in addition to lower prices, investors will find the field is nowhere as crowded with competitors.

So what should out-of-towners expect venturing for the first time into a secondary market? Unlike Boston, where "people are willing to sign on for historically low cap rates because of the trending uptick in rents, in New Hampshire, it's more about current cash flow, not future yield and IRR," says the regional director.

In short, "don't bring major-market expectations to a secondary market," he warns. "There's nothing worse than a developer or investor buying a property, ignoring what you told them, and thinking along the lines of how similar buildings perform in other markets. If you're telling them lease-up will take nine months and they think, 'sure, but we can do it in half the time,' there's a chance they'll end up disappointed. I've seen it happen."

Also, stick with what you know. "If you understand office, pick office," he says. "It's the same with industrial, retail, or apartment complexes."

Farrelly advises first-timers to "make sure you're buying in a market based on the reality of that market's fundamentals and not based just on the appearance of a building and its location."

And probably most important, remember that you can't "just parachute in. You can get your head handed to you. You need local market expertise, and boots on the ground." ■