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Savills World Research
UK Commercial

Spotlight
Office Refurbishments in UK Regional Cities

Summer 2017

Neo, Manchester, above, provides 52,000 sq ft of collaborative, refurbished office space

- Rising construction costs have squeezed developer margins over the past 18 months, and with build cost inflation set to reach 2.9% during 2017, developers have switched their attention to refurbishments.
- The market is starting to see a "new generation" of refurbishments which offer a much higher quality product than ever before.
- A lack of appetite from investors for speculative new development has given rise to a growth in refurbished product.
- We saw the inception of defurbishments in the Shoreditch/ Old Street market, however, defurbishments are now becoming an increasingly important part of the regional office market.
- 38% of the total speculative office space being delivered in the UK regional cities over the next three years, will be in the form of refurbishments.

"Professional occupiers including lawyers, accountants and engineering firms, are now looking for a more creative internal fit-out to inspire staff and attract a younger workforce."
Savills Research

With a tight supply schedule and sustained demand for good quality office space in the regions, refurbishments are providing the quality floorspace required to accommodate demand going forward.

Where Are We Now?

There is currently a lack of appetite for speculative development. Rising construction costs have squeezed developer margins over the past 18 months, and with build cost inflation set to reach 2.9% during 2017, developers have become increasingly cautious over the feasibility of new build schemes.

There is however, a sustained level of demand for space in many of the regional cities alongside a lack of stock, which is influencing demand for refurbished office space. Landlords are looking to refurbishments to capture rental growth and ensure that their product gets to market ahead of the next development cycle.

The market is starting to see a "new generation" of refurbishments which offer a higher quality product than ever before. Refurbishments need to add an extra dimension to make them an attractive alternative to new builds, and we are now seeing a number of landlords spend more on the reception area/lobby as well as installing gyms and cafes to give them an extra edge.

Occupiers' attitudes to refurbished space have improved and rather than being considered inferior, "back to frame" schemes are now becoming interchangeable with new build stock.

Whilst refurbishments can act as the value option for occupiers who require more affordable rents, if they are the only option, they are often more than good enough for most occupiers.

As an example, Helical's pro-active ongoing refurbishment of Churchgate House in Manchester has moved the asset from an historic rolling void of circa 20% to now being fully let. Occupiers have been attracted to a new reception incorporating touch down space, collaborative working areas and a high quality cafe, this has also contributed to moving rents on within the building.

Growth Of The Refurb

Regional office markets are currently seeing an influx of refurbishments, due to a dip in the development pipeline.

The refurbishment market has grown considerably across the UK regions over the last five years. For example, during 2016, refurbishments accounted for 25% of Manchester's Grade A take-up, making it a significant contributor in the market. We expect this proportion to increase during the next 12- 18 months.

In the absence of Grade A office space, we have seen a number of comprehensively refurbished offices delivered. Significant buildings include Programme, Bristol (120,000 sq ft) and 55 Spring Gardens in Manchester (56,000 sq ft).

38%

of the total speculative space being delivered over the next three years will be in the form of refurbishments.

Refurbished space has helped to satisfy the trend for non-traditional office space. The 'defurbishment' (see page 3) was typically the home of the creative or start-up. However, more professional occupiers including lawyers, accountants and engineering firms, are now looking for a more creative internal fit-out to inspire staff and attract a younger workforce.

As the current availability of new build Grade A space in the regional cities is so scarce, developers have looked to refurbishment schemes in the fringe markets. Historically, fringe refurbishments were undesirable, but with many cities seeing the city core expand outwards, fringe locations are becoming increasingly popular. For example, Birmingham has seen significant refurbishment activity around the vicinity of the inner ring road on both Great Charles Street and Suffolk Street as the traditional core expands, complimenting the redevelopment of New Street Station and Paradise Circus.

One particularly active business sector within the refurbishment market has been the tech sector because the rents have generally been more affordable. With tech growth forecast to see around 104,000 jobs over the next five years, we expect to see sustained demand for refurbishments.

However, refurbished rental growth in Bristol has outstripped new build rental growth following a lull in speculative developments. Bristol has seen refurbished rents rise 51% over the last five years, from £18.50 per sq ft in 2012 to £28 per sq ft in 2017, closing the rental differential with new builds from £9.50 per sq ft to only £0.50 per sq ft over this period (see Graph 1).

Leeds' rental differential stood at £0.50 per sq ft until Q2 2017, when top new build rents jumped from £27.50 per sq ft to £30 per sq ft. We believe that the top rent increase was down to the low differential which has subsequently risen to £3 per sq ft, re-rating the market.

Flight To Quality

It is widely accepted that the UK regions are currently at their lowest level of Grade A availability on record, which has reduced the relative risk of a refurbishment project.

In a time where returns will be income led, we are seeing a "flight to quality," as landlords comprehensively refurbish secondary space to attract and retain tenants. This acts to maximise rental income, attract higher tenant covenants and enhance capital value and longevity of the asset.

There also lies an opportunity cost associated with a comprehensive refurbishment in the loss of rental income over an 18-month period when the building is undergoing works. The rental value of new developments in some smaller regional markets is too low for new development to be viable, so refurbished space is the best alternative.

The introduction of Permitted Development Rights (PDRs), has seen the conversion of office to residential across the regional markets. However, with a shortage of office space and

£0.50

per sq ft rental differential between refurbishments and current headline rents in Bristol

rising rents in the regions, we are seeing fewer conversions of office stock under permitted development rights and developers now turning their attention to refurbishments.

From an investors' perspective, strong rental growth in refurbishment opportunities resulted in secondary yields hardening. The prime/secondary yield spread in Manchester now stands at as low as 100 basis points, half that of 12 months ago.

What Next For Refurbishments?

So have refurbished rents peaked and what impact will this have on new build rents?

Graph 1 shows Savills top rental growth forecasts for the regional cities to end 2018. We expect Bristol to be the next city to see a step change in top rents, driven by both a shortage of new build product and a record low refurbished/new build differential of only £0.50 per sq ft (see Graph 1). We expect new build rents to reach £33.50 by the end of 2018, reflecting an 18% increase on current levels.

38% of the total speculative space being delivered in the UK regional cities over the next three years will be in the form of refurbishments, which will act to lift average rents. We feel that we are now at the stage in the cycle where there is an opportunity for landlords to refurbish secondary stock in search of rental uplift and an improved covenant.

THE BIRTH OF THE DEFURB

Exposed surfaces are becoming increasingly popular in the UK regions

We saw the inception of defurbishments in the Shoreditch/Old Street market, however, defurbishments are now becoming an increasingly important part of the regional office market. So what exactly defines a defurbishment?

A defurbishment is where office space has undergone a transformation based on the exposure and enhancement of the existing building's features, including exposed brickwork and high, open ceilings. This steps away from the traditional layout and provides a space which is more collaborative, creative and flexible.

From Savills 2016 What Workers Want survey, workers were most dissatisfied with lighting in the office. By stripping away the suspended ceilings and adopting exposed ceilings, this provides more natural light and has proved particularly effective on lower ground floor office space.

Wellness is becoming an increasingly important factor in the design and delivery of office space. We are seeing rising demand for break out areas in offices, which provide workers with increasingly flexible meeting space, creating a more informal environment. Developers are now increasingly listening to workers' demands and are designing their schemes around co-working space.

One such building which provides occupiers in this sector with 'defurbished' office space is 101 St Mary Street, Cardiff. The owners of this building have successfully created the type of office space provided in such locations as Shoreditch, London, where a number of the tech and creative sectors are clustering.

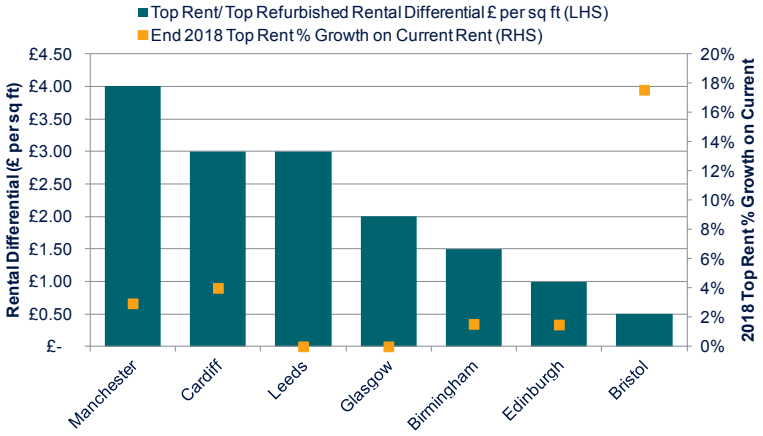
In Manchester, we have seen a number of defurbishments situated towards the fringe locations, particularly the Northern Quarter, where a number of tech and creative occupiers are located. Neo, Manchester, (pictured cover), has undergone a comprehensive refurbishment to provide 52,000 sq ft of collaborative, Grade A space.

One of the disadvantages of undergoing a defurbishment from an investor's perspective is the higher cost. Whereas a typical refurbishment costs an average of £40 per sq ft, a typical defurbishment costs an average of £50 per sq ft, which is largely due to the additional cost associated with re-exposing the surfaces.

In order for the key regional cities to attract and retain top talent, developers must ensure the right blend of collaborative and independent working space is available in order to retain talent and maximise worker productivity in the regional cities.

GRAPH 1

Cities with a low differential between refurbished rents and top rents will see the strongest growth in top rents



REGIONAL REFURBISHMENT TOP PICKS

Where do the refurbishment opportunities in the UK regions lie?

Refurbishments are being delivered within the UK regions and will continue to do so over the next 18 months. A range of refurbished, defurbished and fully redeveloped office product is currently available and offer each occupier a unique working environment.

Below are Savills Research's regional refurbishment top picks:

1

Programme, Bristol

Programme will provide 120,000 sq ft of space with floorplates of circa 16,000 sq ft, and is set to complete during Q3 2017. Located north of Castle Park, Programme is close to retail and amenity offering around the city centre.

The building mixes innovation, art, business and media, establishing modernised workspace for Bristol, featuring fully refurbished open-plan office environments across seven floors.

With a new coffee shop, retail units and a cycle hub with changing facilities and space for 150 cycles, the space is geared towards creative occupiers. Rents are currently in the region of £25 per sq ft.

2

Alpha, Birmingham

Alpha is one of Birmingham's most well-known and widely recognised landmark buildings, extending to 196,000 sq ft over 27 floors. Centrally located between Colmore Row and Brindleyplace, Alpha features column-free floor plates of 7,100 sq ft.

A new ground floor cafe, gym and cycle storage area attract a range of occupiers, whilst the building's floors are undergoing a rolling refurbishment.

The building has benefited from a combination of prime occupiers leasing new buildings around them and enhanced infrastructure from New Street Station and the Metro extension. Subsequently rents have uplifted from £12.50 per sq ft to £19.50 per sq ft.

3

9 Bond Court, Leeds

Following a comprehensive refurbishment, 9 Bond Court provides 63,000 sq ft of contemporary high quality accommodation with spacious open plan offices, benefiting from an abundance of natural light.

Internally, the newly refurbished reception creates a bright and welcoming entrance for clients and reflects the stylish approach that has been taken throughout. This is further enhanced by new, bespoke communal areas and open plan office floors, rich in natural light.

A short walk from Leeds station, 9 Bond Court is located in the central business district and rents have achieved in the region of £27 per sq ft.

4

11 Portland Street, Manchester

Aviva Investors have commenced the refurbishment of 11 Portland Street, Manchester, which will provide single floors of up to 20,000 sq ft. The building occupies a prime location within the heart of Piccadilly, benefiting from the excellent connectivity provided by the transport network within Piccadilly Gardens and Piccadilly Station.

The major refurbishment incorporates an entirely new principal reception area which has been repositioned to the corner of Portland Street and Aytoun Street.

The installation of cycle racks, showers and a refurbished central courtyard complete the refurbishment scheme, which is achieving rents in the region of £23 per sq ft.

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