UK Commercial – Spring 2024

SPOTLIGHT
Savills Research

Regional Office Outlook

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Occupier Demand ● Office Stock ● Prime Supply ● Rental Growth

The evolving demand landscape

The office market is currently experiencing a recalibration in demand levels as corporate occupiers are predominantly rightsizing their portfolios, with hybrid working models being more frequently adopted. The long-term impact of this trend on take-up levels is difficult to assess given the economic headwinds the market has faced in the last two years.

Rising finance costs have deterred some occupiers' propensity to undertake large capital expenditure projects, which has resulted in some office relocations being either delayed or postponed and arguably, therefore, skewing long-term take-up.

A new stabilised level of take-up is, however, beginning to emerge in the post-pandemic era, after two years' worth of transactional activity. Annual take-up levels across the Big Six regional city centre markets were, on average, 11% below the ten-year pre-Covid average. There was positive leasing momentum building by the end of 2023 with Q4 2023 take-up across the Big Six regional markets 4% above the previous quarter. This was more apparent in the Greater London & South East region with H2 2023 take-up 95% above the take-up achieved in H1 2023.

Improved sentiment from occupiers has been most notable from corporates, with Deloitte's CFO Q4 2023 Survey revealing above-average optimism levels on business performance over the next 12 months, and this sentiment, combined with an expected push for the return to the office, bodes well for take-up levels in 2024.

KPMG's 2023 CEO Outlook uncovered that 87% of respondents are more likely to reward employees who have higher office attendance with favourable assignments, raises and promotions. The majority of CEOs are supportive of pre-pandemic ways of working, with 64% of respondents expecting a full return to the office within the next three years. This sentiment has helped drive demand for best-in-class office space. Occupiers accept that a good office space isn't merely a physical setting; it serves as a powerful tool to cultivate, reinforce, and sustain a company's culture. By intentionally designing spaces that align with the company's values and encourage collaboration, innovation, and employee well-being, organisations can create an environment that fosters the desired culture, ultimately shaping the overall workplace experience.

As the workforce seeks a balance between remote and in-office work, these exceptional office spaces emerge as essential anchors, drawing individuals back to the office and redefining the future of work.

As businesses seek to demand 'best-in-class', the traditional Grade A definition is no longer fit for purpose. A new categorisation of office, defined as prime, has therefore been introduced to capture those buildings that have not just the highest quality specification but also respond to the ever-growing need for occupier amenity and far greater levels of sustainability.

This segment of the market is expected to outperform in the next few years, with faster letting velocities and rental premiums being achieved on this type of space.

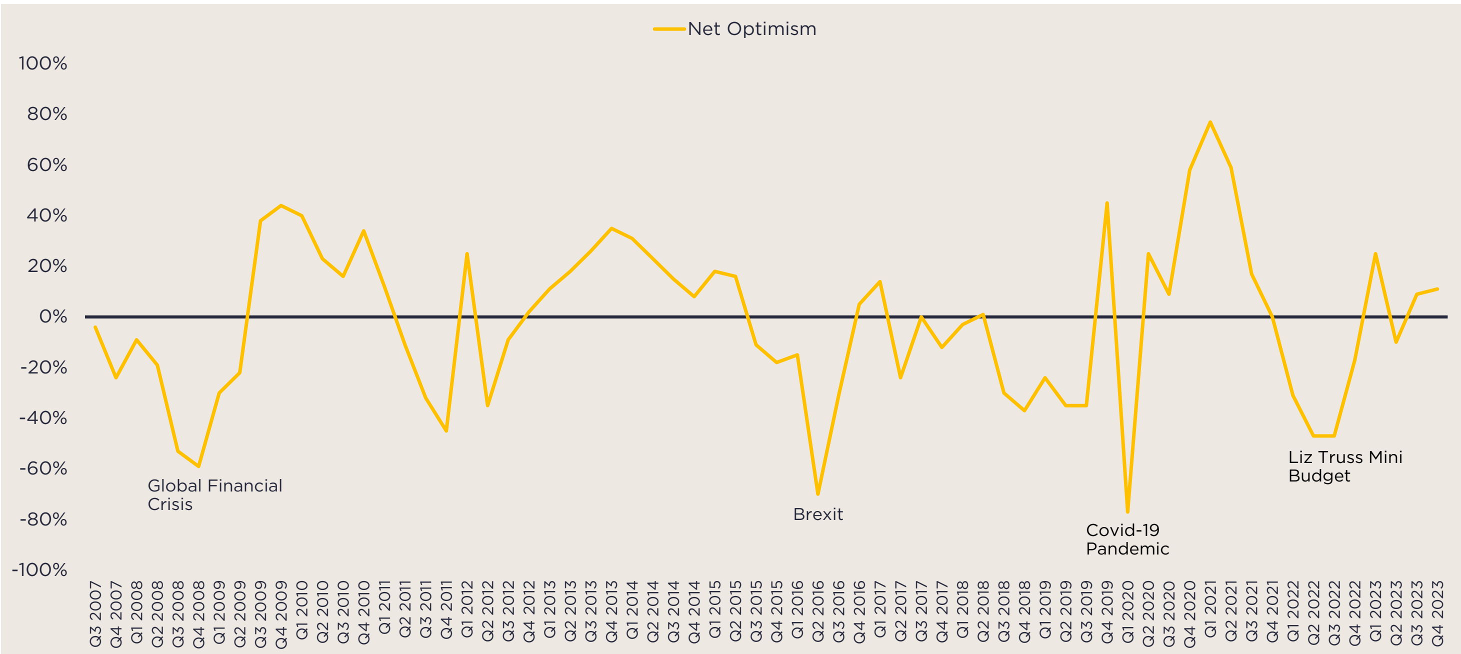
How HR is driving real estate decisions for workplaces

As real estate decisions become more people-centric, HR teams are emerging as key players in selecting buildings that align with organisational needs, enhance employee well-being, manage costs efficiently and ensure legal compliance. By understanding how a building's design and certifications contribute to a better workplace, businesses can attract and retain top talent while fostering a thriving, sustainable environment that bolsters long-term success.

The HR function has taken centre stage, shaping real estate decisions that not only impact culture but also highlight different requirements across various demographics. This ultimately helps to forge a secure, supportive and inspiring work environment which employees genuinely want to return to.

Research consistently underscores the positive impact of providing employees with greater autonomy and control over their workspace. Successful buildings empower their users, allowing them to tailor their space to personal needs. HR is the conduit of the workforce and plays a pivotal role in gathering and analysing information relating to how space is used, employee preferences, workplace satisfaction and performance metrics.

Chart 1 Optimism amongst CFOs is above average levels with the consensus that inflation levels have peaked



Source: Deloitte Q4 2023 CFO Survey

Acceleration of office conversions?

As the demand for best-in-class offices has increased, those assets that don't offer the best in ESG and amenity have fallen out of favour. This has resulted in an oversupply of lower-quality stock in some locations, representing a significant risk to landlords. This reuslts in a mismatch of what occupiers want versus what is physically available.

With refurbishments not always a viable solution for some assets, landlords with problematic office spaces may then find success in repurposing projects, with housing, hotels, laboratories and education providing examples of alternatives.

The weaker demand for secondary office space has accelerated the conversion of offices to alternative uses, which is evident after reviewing the total office stock from the Valuation Office Agency (VOA). The total office stock in the Outer London and South East region has contracted by 15% and 10%, respectively, in the last three years, which is the greatest proportion when compared to other regions across England and Wales. Regionally, the total office stock has contracted by an average of 4%. However, cities including Manchester, Leeds and Glasgow are exceeding this average, and we expect to see increased change of use as we go through 2024.

Education occupiers have been a beneficiary of landlords' openness to alternative uses for certain assets, with an increase in buildings seeking dual consent for both office and education use. Take-up from education occupiers accounted for 272,000 sq ft across the Big Six regional city centre markets. Notably in Birmingham, where the sector was the most active acquirer of office space in 2023, making up 35% of take-up. Leeds and Manchester have also seen a number of deals in this sector over the last 12 months.

The structural drivers behind the increase in demand from education occupiers remain robust, with enrolments rising from both domestic and overseas students. The provision of best-in-class facilities is a key attractor for prospective students as higher education providers seek to secure talent in a competitive environment.

The recalibration of office demand arising from changing working practices can be partly mitigated by reducing stock levels. Permitted development rights were amended by the Government to allow all office buildings, regardless of size, to be converted to residential without full planning permission, in areas which are not covered by Article 4 directions.

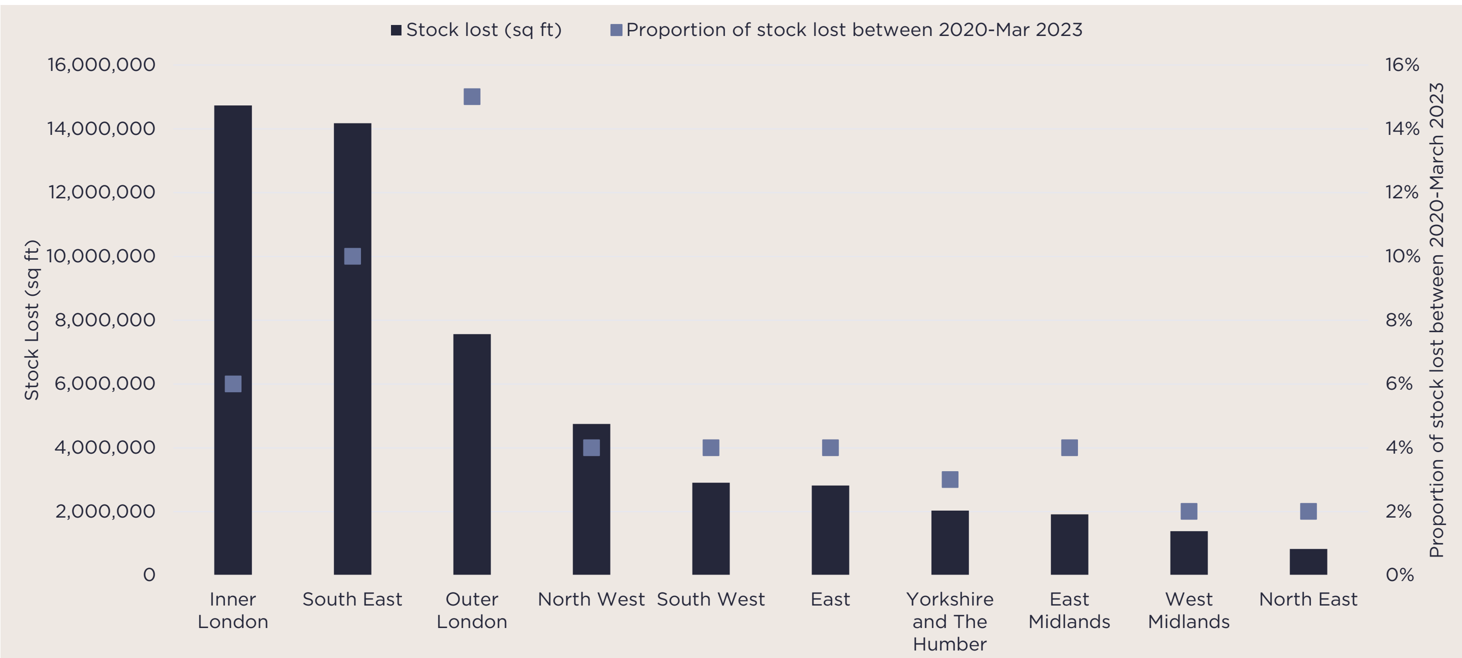
The removal of the floorspace limit may stimulate the conversion of secondary office buildings to residential. This would see the supply levels across the region dwindle and alleviate the potential for significant increase in vacancy rates as poor-quality secondary office space is returned to the market. It should be noted, however, that not all buildings will be suitable for conversion, and it can be expensive to undertake this process.

41%
2023 rental premium on BREEAM-certified buildings compared to non-certified projects

£46
Highest Prime rent in the Big Six achieved in Bristol in Q1 2024

20%
Fitted space will see a rental uplift of c.20%

Chart 2 The South East and Outer London have experienced the greatest reduction in office stock levels on a proportional basis since 2020



Source : VOA

Office space dynamics: Prime supply challenges, and the rise of fitted space

Flight to quality has resulted in an increased polarisation in demand for prime and secondary buildings, which has accelerated since the Covid-19 pandemic. This has been reflected in the proportion of Grade A take-up in both the key regional cities and the Greater London & South East region. In fact, the Greater London & South East region saw the highest proportion of Grade A take-up ever recorded in 2023 at 80%.

However, with all of the Big Six office markets, having less than two years of supply in their markets – Savills believe that anything below two years is considered an undersupply - there is currently a severe undersupply of prime availability in these markets. There is a lack of existing prime space available, with only 17% of current supply being classified as this standard in the Big Six office markets and 12% in Greater London and the South East region.

Rising finance costs and high build costs have impacted development viability across the regional office markets, resulting in a constrained development pipeline. There is just 1.3 m sq ft of speculatively developed space that is set to achieve practical completion over the next three years. However, occupier appetite for this prime space has been evident, with 25% of this combined total either being let prior to practical completion or currently under offer.

With a lack of prime stock, those Landlords that have capital to invest, are taking the opportunity to comprehensively refurbish secondary assets. Over the next three years, 800,000 sq ft of refurbishments are being delivered into the Big Six markets, with notable examples including the Met Tower in Glasgow, Havelock in Manchester and 24-25 St Andrew Square, Edinburgh.

Prime supply constraints present in the market have facilitated significant headline rental growth for best-in-class buildings due to limited competition and a continued 'flight to quality'. Prime rents have proceeded to grow in the last five years, with new developments setting new rental tones in the market.

All of the UK Big Six markets achieved prime rental growth between 2020 and 2023, despite the effects of the Covid-19 pandemic. During this period, rents grew at an average of 16% across the UK Big Six markets, with the first quarter of 2024 already witnessing 7% growth on prime space. Rental premium on BREEAM-certified buildings compared to non-certified projects also stood at 41% in 2023. Savills expects rental growth on prime space to continue over the next five years.

The growing attractiveness of fitted office space

Some smaller occupiers have for many years favoured the provision of fitted space, historically through a serviced office model However, the scale and structure of this sub-sector continue to grow and evolve.

As we continue to navigate various macroeconomic challenges of the past few years, the structural shifts within the office market remain, with increased demand for lease flexibility and a growth in the desirability for flexible workspace, particularly for the many occupiers who are not yet ready to make long-term decisions.

Taking Manchester as an illustration, the city experienced an 18% increase in the number of completed deals in 2023 when compared to 2022, accompanied by a noteworthy 14% rise in the average deal size. The percentage of take-up as fitted space also witnessed a substantial increase, reaching 18.62% of total take-up in 2023, marking a significant rise from the 10.82% recorded in 2022.

It's easy to see why it holds such appeal, particularly in the current climate. Not only does it save an occupier from committing to significant capital expenditure upfront, but it also reduces delivery risk and saves time – a crucial factor for many businesses that are scaling up and want to move quickly through the acquisition process.

From a landlord 's perspective, this alternative specification can speed up the leasing process and attract differentiated occupier types, with a diversity of product appealing to a wider demographic of potential tenants.

Such an approach is not without challenges, given the requirements for capital expenditure; however, with rental premiums of 20%, the leasing case for such a strategy is compelling.

Chart 3 The development pipeline is limited across the Big Six markets for the next three years

Source Savills

Image: Havelock, Manchester

Key points for 2024

1 Quality remains king

In the post-pandemic era, the importance of the best-in-class office building is paramount. A top-tier office environment becomes a strategic asset, attracting talent, enhancing employee well-being, and fostering a sense of community. Given the scarcity of prime office stock, there is a compelling opportunity for those with available capital to invest in secondary assets for refurbishment. This presents a chance to transform existing properties into high-quality office spaces that meet the evolving needs of businesses and employees in the post-pandemic landscape.

2 Upsizing or downsizing?

While some occupiers are considering acquiring less space, the overall impact may not be as substantial as initially anticipated. According to KPMG's 2023 CEO Outlook, 87% of respondents are inclined to reward employees with higher office attendance through favourable assignments, raises, and promotions. Despite the changes brought about by the pandemic, the majority of CEOs express support for pre-pandemic work practices, with 64% anticipating a full return to the office within the next three years.

3 Acceleration of office conversions?

Landlords with problematic office spaces may then find success in repurposing projects, with residential, hotels, life sciences and education providing examples of alternatives. The weaker demand for secondary office space has accelerated the conversion of offices to alternative uses, which is evident after reviewing the total office stock levels from the VOA.

4 The emergence of fitted office spaces

There is a growing demand for fitted spaces in regional cities, leading landlords to integrate more of these ready-to-use suites into their assets.

The allure of fitted spaces lies in their capacity to save occupiers from significant upfront capital expenses, mitigate delivery risks, and streamline the leasing process. Landlords benefit by attracting a diverse range of occupiers with alternative specifications, appealing to a broader tenant demographic. Fitted spaces also tend to command an average rental premium of 20% on traditional leases.

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