

Spotlight The Future of Manchester

December 2015



SUMMARY

Manchester is facing a decade of strong growth but the city needs to build more to meet demand

■ Lower property and staff costs are a draw to companies moving or expanding out of London. But Manchester needs at least a further three million square feet of office space and almost 100,000 new homes over the next decade to meet this rising demand. p.2-3

■ The combination of developer and funder caution is still unlikely to deliver enough new real estate over the next decade to satisfy the demands of this growing city.

■ Failure to meet demand could not only inhibit the growth prospects of local businesses (as rents inevitably rise), but also could make it harder for the city to attract companies looking for a home in one of Britain's regional centres.

■ As permitted development rights are extended and made permanent, our research shows that there is a clear value advantage in converting commercial space into residential in three of the nine areas we analysed. p.4-5

■ The city will need to expand to meet demand. We track the development hotspots for the next decade. p.6-7

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 “Lower property and staff costs are a draw to companies moving or expanding out of London”
 Savills Research

Market dynamics

A DECADE OF GROWTH AHEAD

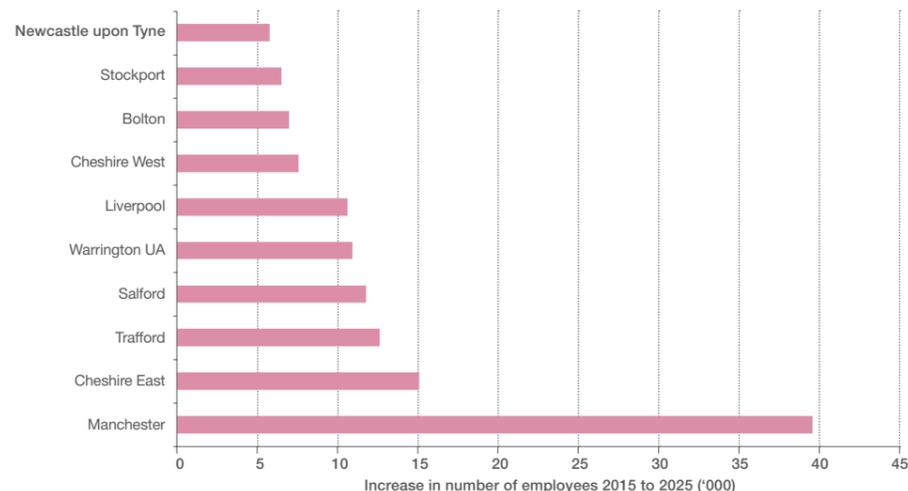
Manchester needs at least a further three million square feet of office space and almost 100,000 new homes over the next decade to meet rising demand

Even before the idea of a Northern Powerhouse crossed the Chancellor's desk, Greater Manchester had established itself as Britain's second city in terms of regeneration, growth and governance.

Employment growth in Manchester has been faster than in any large UK city, with job creation being relatively broad-based across sectors. More professional services jobs have been created in the North West than Greater London over the last 12 months, many of them in Greater Manchester. Indeed, 57,000 jobs have been created in central Manchester since 2011 – more than double the rate of growth in either the North West or the UK as a whole.

This strong growth is down to a number of structural factors, including the city's well established strength in financial services, business services and education. The city has also benefited from the return of 'northshoring', where companies are moving or expanding out of London

FIGURE 1 Top 10 northern local authorities by projected employment growth



Source: Oxford Economics

and the South East to take advantage of lower property and staff costs. These factors are underpinned by a rapidly growing population, especially of graduates and young professionals.

With office rents in London now at record high levels, the 'northshoring' story is not going to go away. We estimate that the cost saving per employee for a company considering a move or expansion from central London to Manchester could be as high as £10,000 per person per annum in property costs, and £10,000 per person per annum in staff costs.

As a result, we believe Manchester's underlying strengths will play a greater part in the outlook for the North West region than policy initiatives. It is likely that a small number of Local Authority areas will account for a large share of the region's overall growth. The majority of these will be in Greater Manchester. We remain slightly sceptical about the impact of the 'Northern Powerhouse' initiative for the whole of the North East and North West.

Growing demand

Strong growth is not without its challenges. We estimate that Manchester and Salford will need to accommodate 36,000 more office workers over the next decade. At a relatively conservative occupational density of 1:8, this implies a need for a further three million square feet of office space over the next decade, or nearly four million square feet at 1:10 ratio.

The housing market faces similar challenges, with Oxford Economics projecting that the resident population of Manchester and Salford will rise by 65,500 people over the next decade. There has been an undersupply of new homes in the city in the recent past with just 4,500 net additional dwellings per year in Greater Manchester between 2010 and 2015. This is less than half the 9,654 new homes that should be provided every year according to the districts that make up Greater Manchester.

Gap in supply

However, the combination of developer and funder caution is still unlikely to deliver enough new real estate over the next decade to satisfy the demands of this growing city.

We estimate that over the next three years one million square feet of new office space will be delivered, with a further half a million square feet of refurbishments of existing building

planned. This will leave a significant gap between demand and supply.

Failure to meet demand could not only inhibit the growth prospects of local businesses (as rents inevitably rise), but also could make it harder for the city to attract companies looking for a home in one of Britain's regional centres.

Housing

The imbalance between supply and demand against a backdrop of an improving economy is underpinning residential values. House prices rose by 3.3% in the year to September 2015, pushing the average cost of a home in Greater Manchester to £111,567. However, Manchester house prices remain below the average for England & Wales which has reached £186,553, according to Land Registry data.

After a period of little activity throughout the economic downturn, housebuilders are responding by delivering more homes. There are 2,500 homes under construction in central Manchester and Salford at present, according to Glenigan and Land Registry data, and 627 new homes were sold in central Manchester in the year to June 2015.

One key feature of Manchester's residential property market is the fast expansion of the private rented sector, particularly among students and young professionals. The number of households renting privately in central Manchester and Salford rose by 436% between 2001 and 2011 and now represents 63% of households in the city centre.

The prospects for residential investment have greatly improved over the past 18 to 24 months in Manchester. Most city centre schemes are achieving values in the region of £300/sq ft with realisable rents of about £17/sq ft to £20/sq ft. Gross yields are around 6%.

As a result, Manchester has become a focus for investors including Housing Associations, Private Companies, UK and European Institutions, Private Equity, and the HCA as well as overseas capital from the Middle East, China and US.

However, much more is needed. The rest of this report examines the capacity of Manchester and Salford to deliver new commercial and residential space, and focuses on where the best values might be achieved for developers. ■

Millennium footbridge and The Quays in Salford Quays



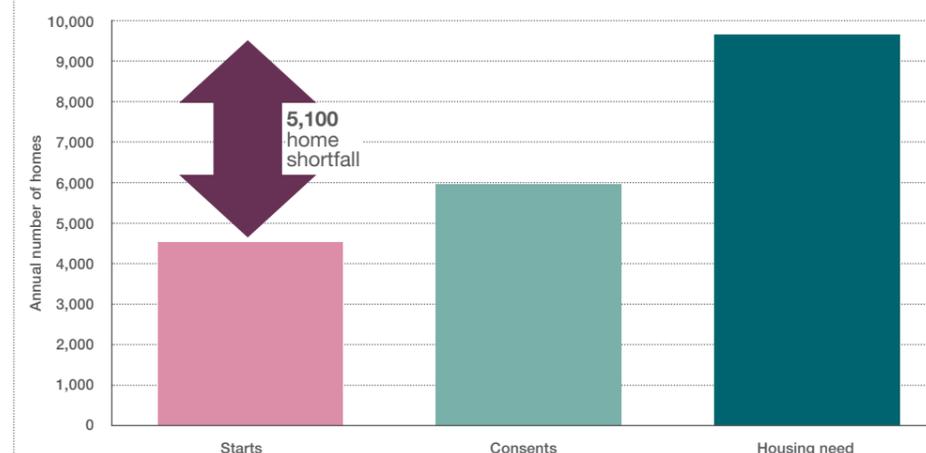
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Jobs created in central Manchester since 2011



Manchester has become a focus for investors

FIGURE 2 The residential supply and demand imbalance



Source: DCLG, year to June-15, district SHMAs

Planning reforms OFFICE OR RESIDENTIAL?

Compared to both London and some other regional cities, Manchester and Salford have seen relatively little office to residential conversion during the latest cycle. We expect to see more conversions over the next five years, now that Permitted Development Rights (PDR) have been extended and made permanent. This trend will be driven by both the limited supply of developable land and rising differentials between the capital values per square foot that are achievable on the different uses.

The map looks at the capital values per square foot that are currently achievable on comparable office and residential developments in different parts of Manchester and Salford. We have assumed that the decision facing a landlord or developer is whether to redevelop the property for office use, or go for a residential conversion. We have also assumed that the office building is in an area which is suitable for residential use. Also, we have ignored the very highest residential values in each location, as most markets can only support a handful of such schemes, and the extra fit-out costs to get to this peak level can be double the norm.

Our experience tells us that even without the need to go through a traditional planning process, you need to factor in at least £100/sq ft for a basic office to residential conversion.

This simple analysis highlights three areas where there is a clear value advantage in converting commercial space into residential, and two submarkets where the case for developing office space is more solid.

Planning changes

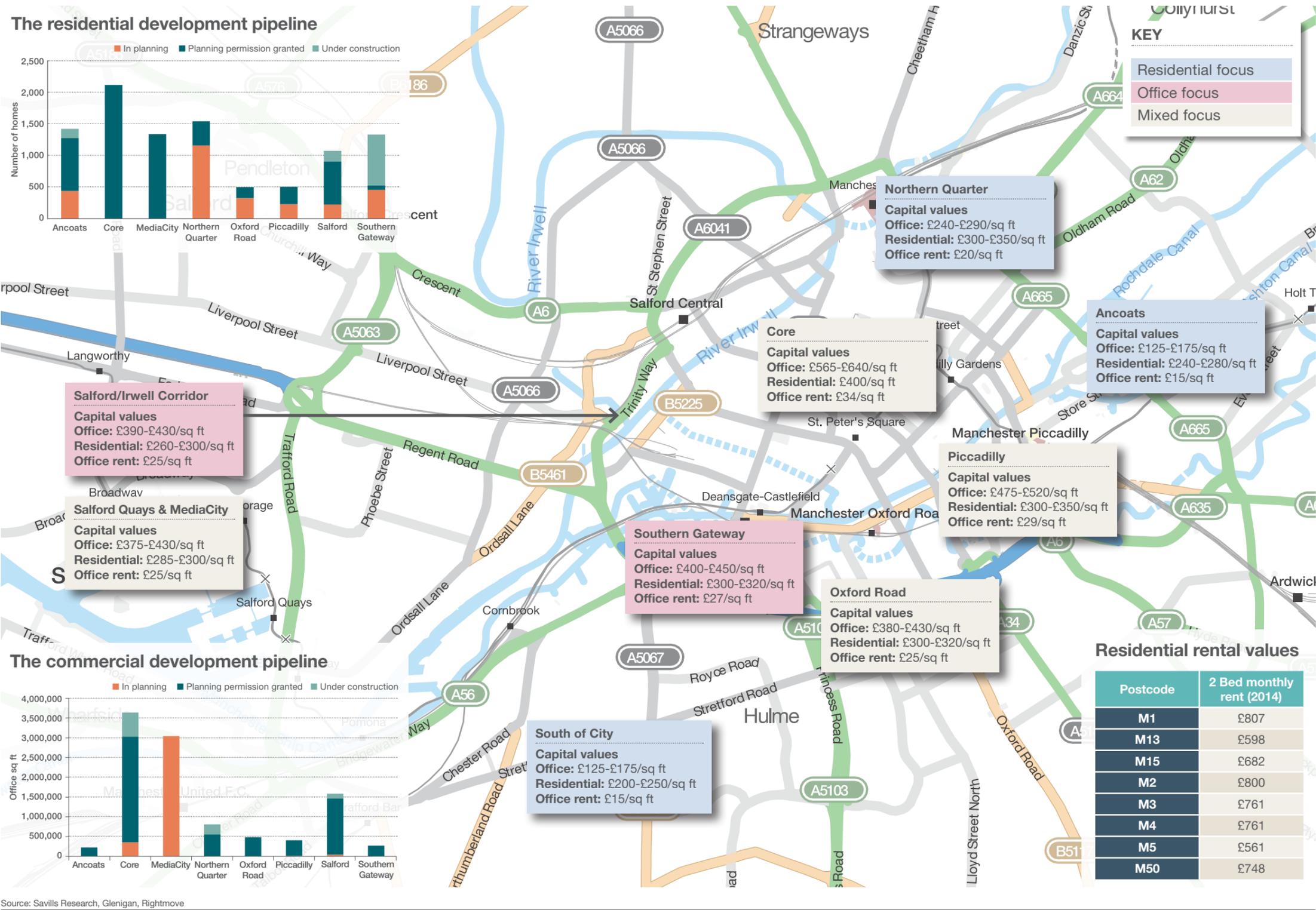
In October, the Government announced that PDRs allowing office to residential conversions will be made a permanent part of the planning system and expanded to allow the demolition of office space and the conversion of light industrial space to residential.

In theory, this change of policy should facilitate a surge in the conversion of unused or under-used commercial space to much needed housing. Historically a large number of office buildings have been unsuitable for conversion, due to their construction or configuration. However, the cost of conversion will still remain high and therefore likely to take place only in locations where there is a substantial differential between the office and residential capital values.

Furthermore, plans to allow local authorities to set their own business rates and to keep the proceeds present councils with a tough choice between delivering more homes via PDR, potentially reducing their income from business rates or increasing their income from rates at the expense of housing.

Manchester city centre is one of the 17 areas in the country that successfully managed to achieve exemption from the first round of the PDR initiative, and we expect that this will be maintained. However, the potential for a loss of employment generating uses elsewhere in the city is significant and will hit public finances even harder than it might have done in the past.

As permitted development rights are extended and made permanent, we analyse the conversion conundrum in Manchester and Salford



Source: Savills Research, Glenigan, Rightmove

Future hotspots WHERE NEXT FOR DEVELOPMENT?

While the immediate response of many developers is to demolish and build new commercial space, this will only satisfy part of the city's need

The delivery of new commercial space will undoubtedly centre around the existing cores of Spinningfields and Piccadilly, but rising office rents in these areas may well push some existing occupiers out into the city's "future core". This will raise challenges for the city in terms of the supply of refurbished and affordable workspace.

Savills report for CityCo in 2012 highlighted a significant gap in workspace provision at the £10-£20/sq ft rent band and suggested that this would be a particular problem for the Manchester's fast growing TMT sector. Given that this sector is forecast to see employment growth of more than 4% per annum over the next decade, this remains a major challenge for the city. While there are a number of

refurbishment projects in the pipeline, our analysis of the current level of availability and the historic levels of lettings at different rent bands points to a high level of undersupply of lower rented space.

For example, 80% of the lettings over the last decade have been at rents in the £10-£25/sq ft range, but currently only 60% of the available office space is in these rent bands.

We believe that this represents a refurbishment opportunity for existing landlords, and we expect to see a rise in such activity in edge of core areas such as the Northern Quarter and Piccadilly.

DEVELOPMENT HOTSPOTS FOR THE NEXT DECADE

■ CORE: With much of this area currently protected from the conversion of office space to residential under the PDR regime, we expect to see a balanced pattern of development in the years ahead. Office development will be focused on high specification new builds, which will be competing for the pool of large indigenous businesses, as well as that of the northshoring market from London and the South East.

■ MEDIACITY & SALFORD QUAYS: With significant office and other uses planned for the later phases of MediaCity, we expect this area to continue to evolve as "the Canary Wharf of the North". We expect that the business mix will broaden from its current media focus to a more diverse base of occupiers who are unwilling to pay the high rents in the core. An enhanced retail and leisure offer will be fundamental to the future success of this area, and we expect to see further mixed-use development around Dock 9 and Ontario Basin to join up with Exchange Quay.

■ SALFORD/IRWELL CORRIDOR: At present the higher residential values that are achievable in this area will encourage residential development over commercial. However, the delivery of major projects such as Middlewood Locks will dramatically enhance the attractiveness of the area for all types of uses, and we expect that office development will become more prevalent in future years, particularly around Salford Central station.

■ SOUTHERN GATEWAY: The improvement to the cultural offer and place at First Street will lead to further office and retail development in this area. We expect that this will become a popular location for large cost-conscious office occupiers who wish to be close to the core.

■ SOUTH MANCHESTER: After a long period of decline, we expect to see a rise in occupier interest in the affordable South Manchester business park market. While the comparatively low capital values are unlikely to stimulate much development, the opportunities for the refurbishment of existing space to cater to both in and out-migrators are significant in this submarket.

■ OXFORD ROAD: Sitting between the business and educational cores of the city we expect this area to be one of the most sought after for developers over the next few years. The combination of a number of strategic sites, the high footfall from the universities, and strong heritage will lend itself to the delivery of a variety of mixed-use projects, with a heavy focus on placemaking.

■ PICCADILLY: This area has a number of large strategic sites that we expect to evolve into the future extension of the City's current core. Residential development is likely to lead the regeneration of this area, with larger scale commercial development following once HS2's arrival becomes more imminent.

■ ANCOATS: Proximity to the core plus the availability of land and convertible commercial buildings are key to the ongoing regeneration of New Islington and Ancoats. The £1bn joint venture between the city council and Abu Dhabi United Group to build up to 6,000 new homes is supporting the transformation of the area and will deliver homes for rent.

■ NORTHERN QUARTER: Already established as the Shoreditch of Manchester, we expect to see a steady stream of good quality office refurbishments being delivered in this area. We also expect to see rising demand from serviced office and co-working companies for space in the area, catering to the rapidly growing media and technology sector.

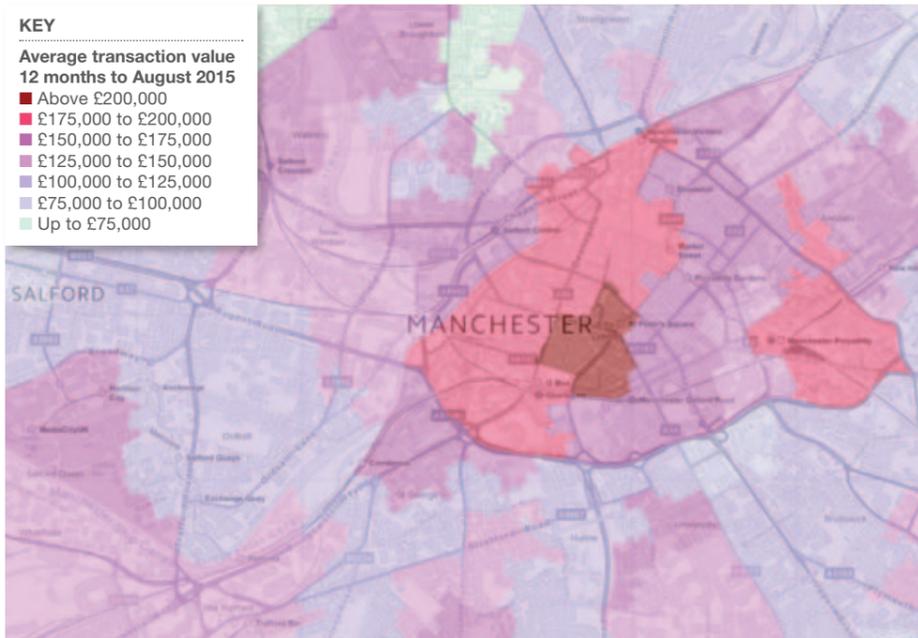
▼ The iconic NV Buildings on the waterfront at Salford Quays



Office rents
£33/sq ft

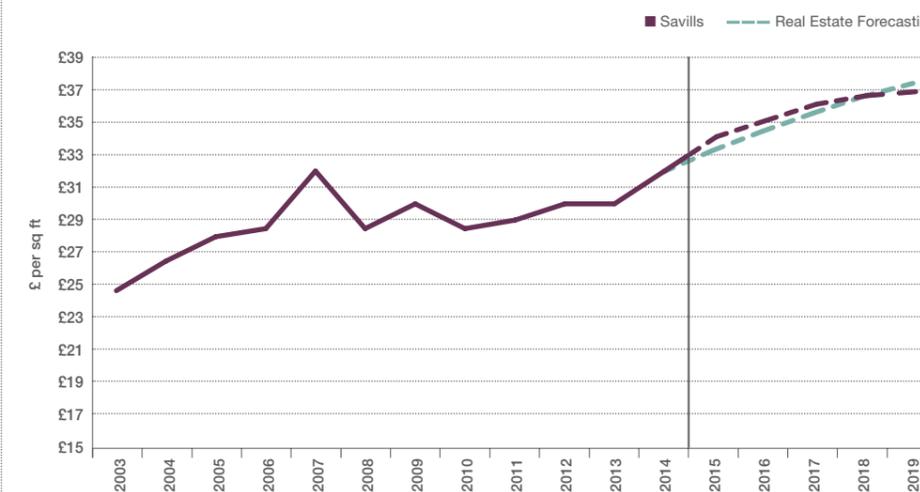
"We expect MediaCity and Salford Quays to continue to evolve as 'the Canary Wharf of the North'"

FIGURE 3
Residential transaction values



Source: HM Land Registry

FIGURE 4
Outlook for Manchester office rents



Source: Savills, Real Estate Forecasting

OUTLOOK

■ **The devolution agenda**, which will give a directly elected mayor powers over transport, housing and planning, **will help instigate development**. The reforms include the £300m Greater Manchester Housing Investment Fund which is expected to deliver between 10,000 and 15,000 new homes over the next 10 years.

■ Plans for the second leg of **HS2**, joining the West Midlands to the north of England by 2032-33, **will act as a catalyst for further regeneration**, particularly around Manchester Piccadilly station which will be expanded on the north side to accommodate the new line.

■ In the medium term, there is plenty of **scope for Manchester's real estate market to play catch up**. The rise of London house prices has seen the gap between the capital and other regional cities widen to its greatest level in decades.

■ **In Manchester**, average house prices are less than a quarter of the London average. Homes are also **more affordable** at seven times average earnings, compared

with London where homes cost 16 times the average wage.

■ This difference in house prices is reflected in the cost of residential land. While the **cost of land** in central London is now well above peak levels, brownfield sites in **Manchester remain 60% below peak**. Such a gap could work in Manchester's favour, attracting investors and developers who seek to expand into more affordable markets.

■ However, the rising demand for more homes is unlikely to be fully met by the pipeline of new homes. **Years of undersupply** have left the city not only with a current **annual shortfall** of 5,100 but also a **mounting backlog** which has grown to almost 40,000 homes.

■ Given these supply constraints, we **expect house price growth** in the city **to outperform the North West** regional average which we forecast will grow by 13.7% in the five years to 2020.

■ The city also **scores very well on affordability of staff and commercial**

property. We expect this to stimulate continuing demand for office space from both indigenous, northshoring, and inward-investing businesses.

■ We expect that **prime office rents** will reach **£37/sq ft** by 2019, and secondary rents will rise to £28/sq ft over the same period. While this is good news for landlords and developers, it will present a challenge to local businesses of all sizes.

■ In particular, we believe that there will be a **shortage of mid-priced refurbished office space** aimed at the TMT and SME sectors, and this **gap in the market is not likely to be filled by the major national developers**. This potential undersupply could be further intensified by a rush of office to residential conversions outside the city centre.

■ **Balancing the needs of residents and businesses** could well become one of the **biggest planning challenges** for Manchester over the **next five years**. Failure to meet demand for both housing and employment space is one of the biggest threats to the city's growth.

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Manchester Development team

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