Real value in a changing world

Permitted Development Rights for Change of Use from Commercial to Residential

February 2013

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1 Introduction

You have asked us to update our report dated October 2011 entitled "Potential Impact of Use Classes Order Relaxation for Change of Use from Offices to Housing in City Office Stock," and to extend it to include the West End (i.e. the bulk of the Central Activities Zone) and Docklands.

We have commenced this task but, given the timetable for responding to the consultation, this note is a commentary on our expected conclusions and this will be supplemented by the fuller analysis in due course.

The office markets in the West End are significant with a stock (91.3m sq ft or 8.48m sq m). By comparison with the City and Docklands, there is less of a concentration on accommodating large financial users and, as a result, on average, the buildings are smaller. The character of the locations are already mixed use with long established residential communities in, for example, Mayfair, Pimlico, and Belgravia, alongside core office locations in Mayfair/St. James, Victoria, Paddington, Midtown, and North of Oxford Street.

The office markets in Docklands are focused on Canary Wharf and the north Isle of Dogs area. Total stock amounts to 20 million sq ft. Within the Canary Wharf Estate itself, the buildings have large floor plates. Beyond the S106 Charging Zone, buildings are smaller and more appropriate for conversion.

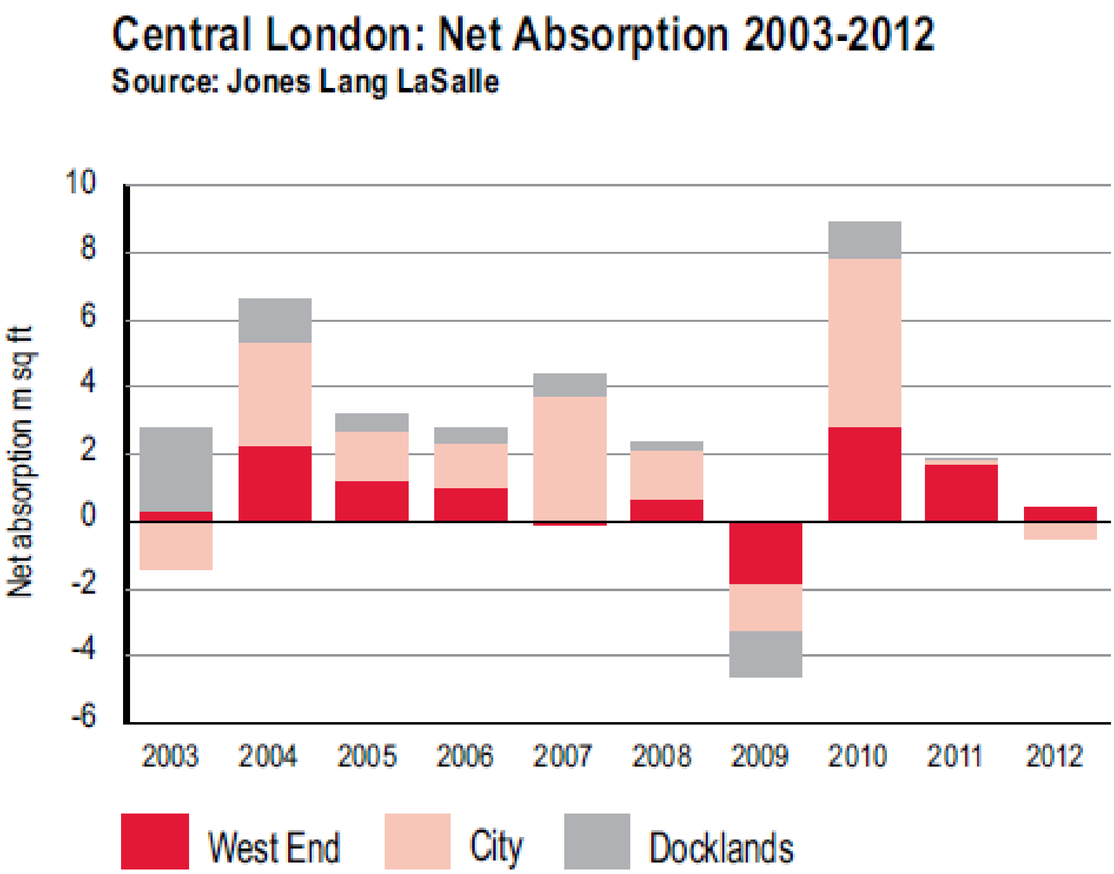
The residential value levels in Central London are such as to encourage conversion to residential use, even in core office locations. When buildings fall vacant, many could convert to residential and, if this was possible under the General Permitted Development Order (and thereby 'avoiding' affordable housing requirements and S106 obligations), there would be a powerful incentive to convert many existing office buildings to residential where the existing building form already maximises (in height and massing terms) the use of land.

2 The Central London Office Market – 2012

7.2 million sq ft of Central London (City, West End and Docklands) offices were taken up in 2012, compared to an average annual take up over the last ten years of 9.3 million sq ft. This below trend take up is explained, principally, by a lack of activity in the banking and finance sector. Of this 7.2 million sq ft, approximately 5.0 million sq ft was Grade A.

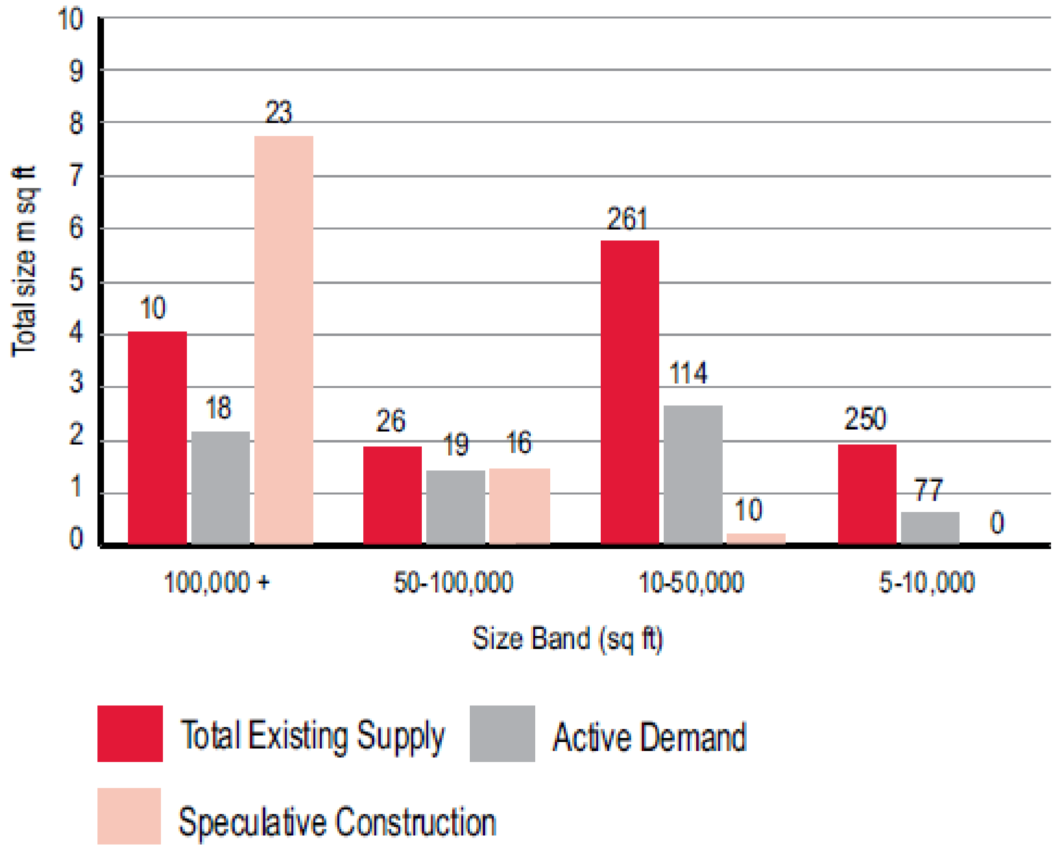
The total vacant space in the same area at the year-end was 13.4 million sq ft. Of this, 10.4 million sq ft was Grade A space and only 3.7 million sq ft was new development. However, an additional 6.3 million sq ft of speculative development is underway and will feed through to the availability statistics over the next three years. The majority of this new space will be in the City.

The amount of space under construction is a relatively small pipe line by historical standards and there will be little added in the foreseeable future. Even assuming a continued depressed rate of annual take up of say 5.0 million sq ft of Grade A, this represents only three years of supply.



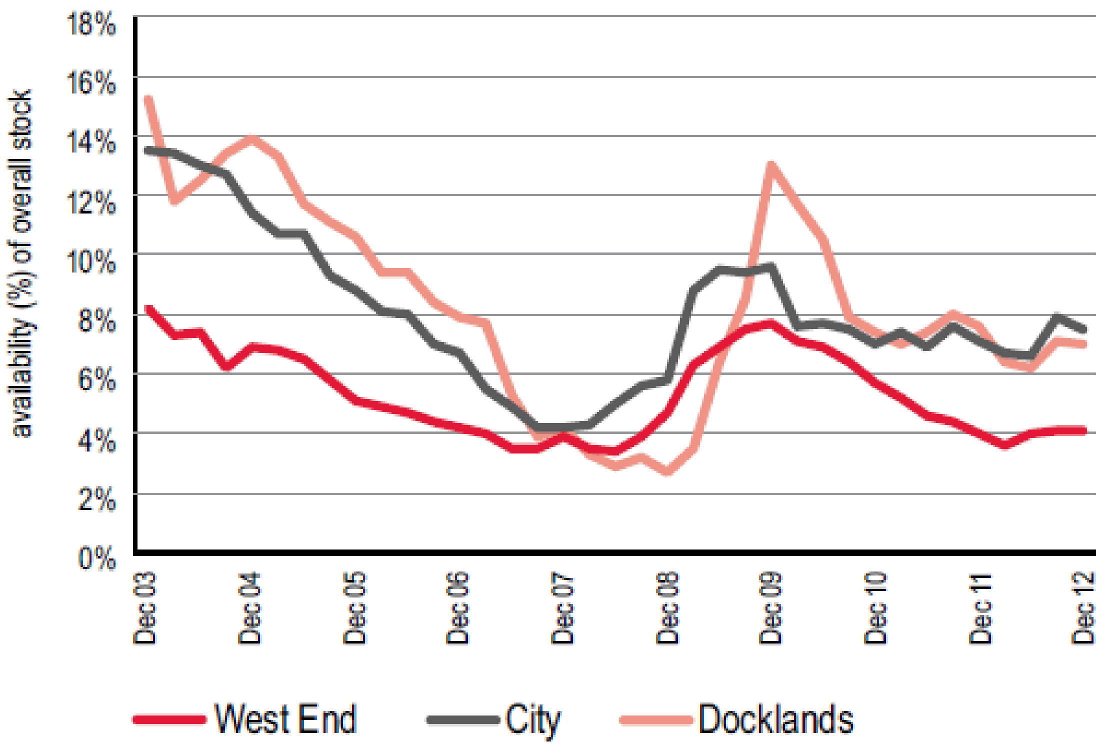
Central London: Demand and Supply Balance 2012

Source: Jones Lang LaSalle



Central London: Vacancy Rates 2003-2012

Source: Jones Lang LaSalle



3 The Central London Residential Market – 2012

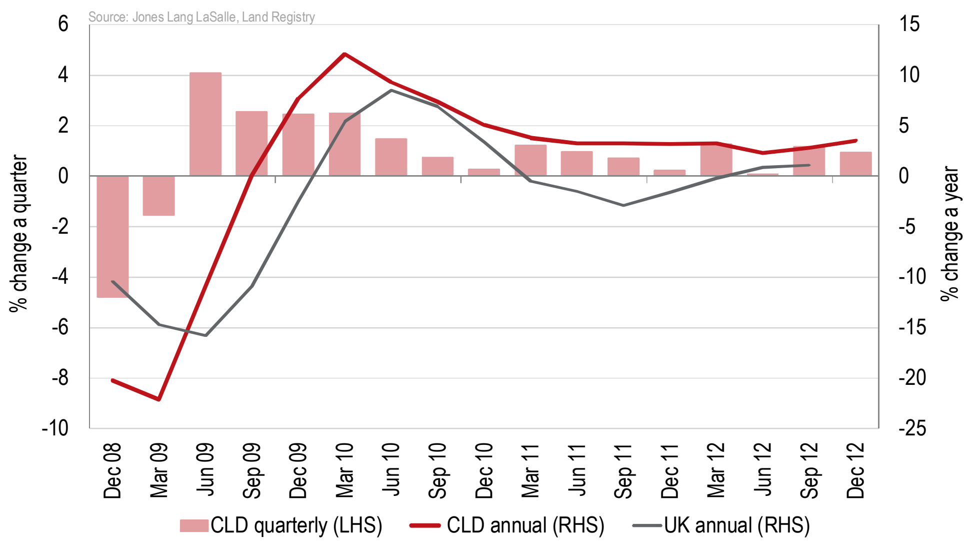
Demand in the new Central London residential development market was higher in 2012 than in 2011. Interest increased from both overseas and UK buyers, with domestic investors making a notable return to the market. Prices have been forced higher by the demand and supply imbalance, but the unsupportive and uncertain global and UK economic backdrops have tempered price rises.

International demand for Central London residential property has increased over the last year. With heightened demand from the likes of the Middle East and Turkey, as well as mainland China, Indonesia and India, competition for stock is intensifying.

Residential demand from UK buyers has been relatively quiet over the past few years with access to mortgage finance and a subdued economy playing fundamental and important roles. Although the economy is still in the early stages of recovery, domestic buyers are now returning in greater numbers. The expanding and flourishing London rentals market is a clear driving force, but the additional demand is certainly helping to support and push values upwards.

The increasingly strong demand picture coupled with the restricted volume of development has helped force values higher. New Central London residential prices have been rising steadily since early 2009. Over the past two years price growth has been quite sedate at around 3-4% pa, but given the economic backdrop worldwide, in the Eurozone and in the UK, the fact that prices have risen in every quarter during this time is testament to the attraction and advantages of the London residential market.

New Central London development price growth



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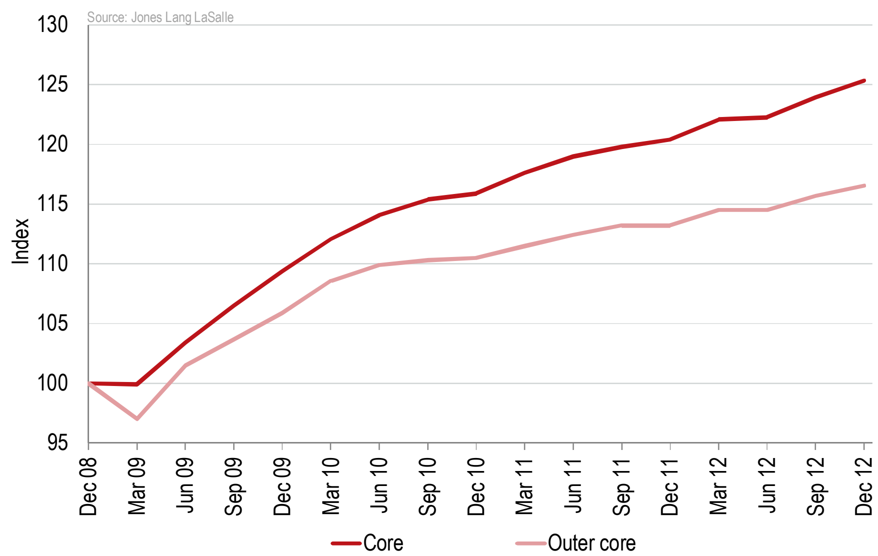
Core locations continue to outperform



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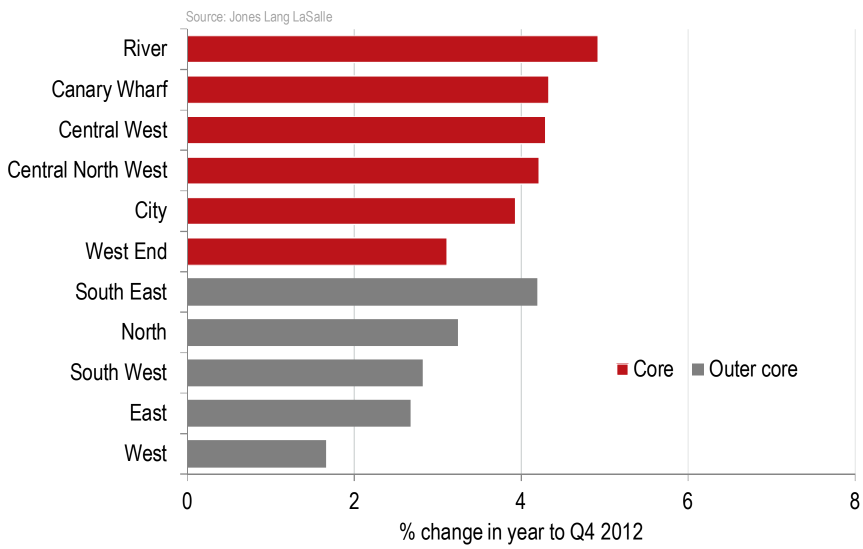
New Central London development price growth



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4 The Longer Term Perspective

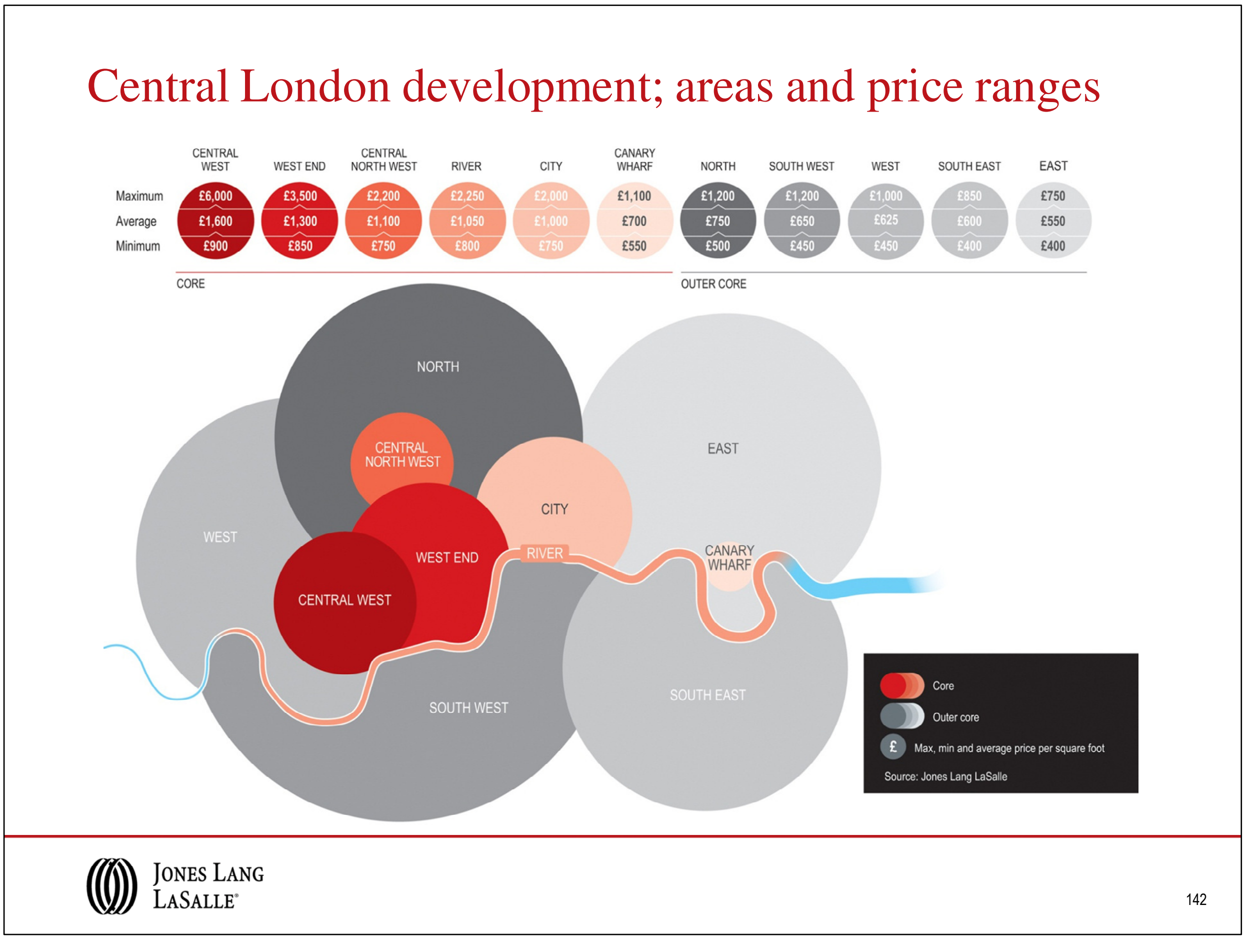
It is interesting to reflect on the scale of change in recent decades. London's stock of offices has increased by 41% since 1984. Most of that growth has taken place in the City and Docklands, where 50.4 million sq ft has been added to the stock. The West End, over the same period, has acquired an additional 12.0 million sq ft. Of course, Docklands and Canary Wharf have grown from almost nothing, but the City has expanded by 39% and the West End by 16%.

Office employment in London doubled over the same period, so expansion was necessary to accommodate the additional demand. The current vacancy rate of 6.1% demonstrates that there is a healthy balance between supply and demand. But the magnitude of expansion in the City compared with the West End does, at least in part, explain the differential in rental growth between the two markets. While the City's rents have remained broadly stable in real terms since the mid-1980s, the heart of the West End has experience significant growth.

From a residential standpoint more people moving into London, UK based buyers coming back in to the market, a strong residential rental market and institutions looking at residential investments as part of a balanced portfolio all point to continuing demand for Central London residential in the short to medium term.

5 Relative Sales Values

The graphic below shows maximum and average sale values per sq ft across Central London as at December 2012.



Looking, for example, at the West End maximum sales prices are c. £3,500 per sq ft which compares with a maximum office capital value of say £2,000 per sq ft. .

6 Other Factors

On a building by building basis there will be many other factors to consider when judging the relative merits of office and residential development, including the respective costs on conversion/rebuilding and the availability of funding.

One of the most important at present is funding. The relatively risk averse environment means that financiers are looking for occupational commitment. For offices this manifests itself as a pre-letting but office occupiers are also risk averse and do not want to pre-commit against a background of uncertain economic circumstances. Therefore pre-lettings are rare.

This paucity of finance for speculative developments has tended to favour residential where selling units "off plan" assists funding as the lender can see that money will be received when the buildings are completed to cover most or all of their loan. Also well capitalised house builders have access to their own capital for development.

7 Conclusion

Past experience demonstrates that there is a significant cycle in office value and an even more pronounced cycle in office development starts accentuated by big swings in occupier sentiment and in the availability of development finance.

In our opinion the mixed office and residential communities in the West End and Midtown are not “broken”. The cyclical office market and scarcity of finance is currently favouring residential but this will change over time particularly if encouraged by a pro-business economic and planning policy. The vibrancy of these locations depends on nothing upsetting the current balance and a rush to benefit from what might be perceived as a temporary relaxation of ‘normal’ planning controls might have this effect.