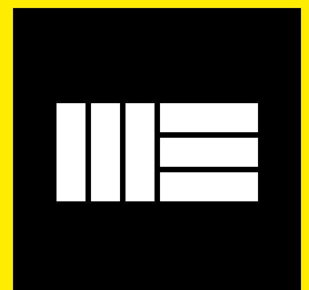
MONTAGU EVANS PRESENTS...

FUTURE SHOCK: THE COMING WAVE OF OFFICE OBSOLESCENCE



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EXECUTIVE SUMMARY

AROUND A THIRD OF THE UK'S OFFICE STOCK WILL BECOME REDUNDANT OVER THE NEXT TEN YEARS.

Long-term structural shifts are fundamentally changing the patterns of occupation, investment and development within the sector. There are huge consequences which reach beyond the property industry to wider business and local communities and both local and central government.

Although the purpose-built office has only been a major feature of our cities for less than two centuries, it has become central to our working lives, to pension fund portfolios, and to city economies – all of which will be disrupted by the coming wave of obsolescence.

The office will remain a major feature of our cities. But the overall stock is likely to be smaller and even more concentrated in a handful of locations. This report outlines the likely shape of this future shock.

THREE TRENDS ARE FORCING RAPID STRUCTURAL CHANGE ON THE MARKET...

01 ECONOMIC URBANISATION

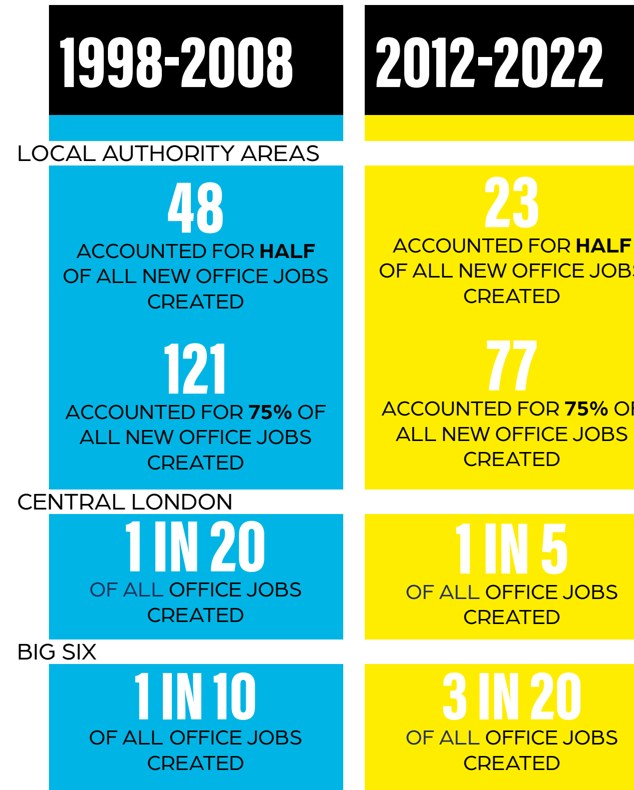
Office-type employment has become increasingly concentrated in city centres over the past twenty years. Over the decade to 2022, almost half of all new office jobs created were in London and the six most important regional cities; this compares with around a quarter over the decade leading up to the financial crisis. This reflects a combination of the benefits of agglomeration, a corporate "war for talent" – which makes the most accessible locations most desirable – and the tendency for younger people to live in more urban contexts than previous generations. This process seems likely to continue, with office-type employment increasingly concentrating in city centres – with the exception of a few locations (notably around the Oxford-Cambridge arc) where there are particularly strong industry clusters.

02 ENVIRONMENTAL OBSOLESCENCE

With it potentially unlawful from 2030 to let a building with an Environmental Performance Certificate (EPC) of C or below, between 70% and 80% of the UK's office stock is in danger of becoming unviable. Of course, much of this stock – especially in London and perhaps in the most important regional centres – can realistically be upgraded. But the problems are more intractable in some out-of-town markets as well as smaller cities and towns. In these settings what is available in terms of rental evidence has not supported development – and in many cases even refurbishment. Some risk being trapped in a vicious circle of underinvestment and low activity. This is not just about legal requirements; occupiers and investors will increasingly only consider buildings with strong sustainability credentials.

03 CHANGING WORKING PATTERNS

While many executives seemed initially satisfied with remote working when it was forcefully introduced during the pandemic, the mood music has changed and the importance of physical presence is being reasserted. However, while attendance has increased to, on average, around 60-80% of pre-Covid levels, this return has slowed somewhat, suggesting a ceiling may be being reached. 'Hybrid working' – a combination of remote and office – is here to stay. Some companies may choose to reduce space as a result of lower average utilisation. But greater flexibility enhances the appeal of the best-quality offices in the most accessible locations, compared to the periphery.

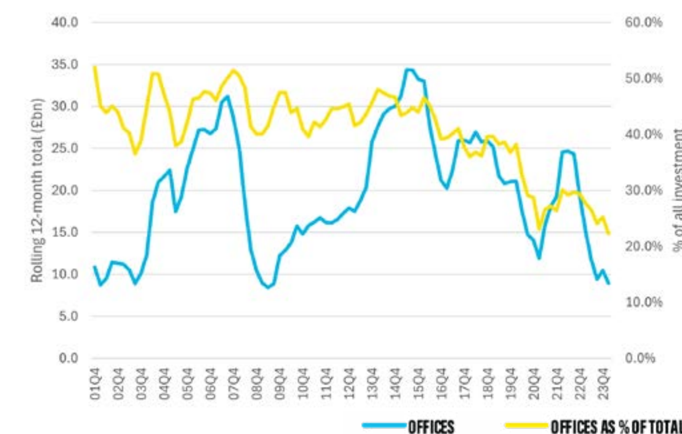


SOURCE: MONTAGU EVANS / OXFORD ECONOMICS. ALL FIGURES ARE APPROIXMATE.

WHAT IS THE MARKET EVIDENCE?

These trends are already apparent in the market. Office investment has been in decline as a percentage of the UK total since 2014 with activity increasingly focussing on a smaller set of investable assets. Recently, office transactions have represented less than a quarter of the total, compared to around a half a decade ago.

UK OFFICE INVESTMENT TOTAL AND AS % OF ALL INVESTMENT



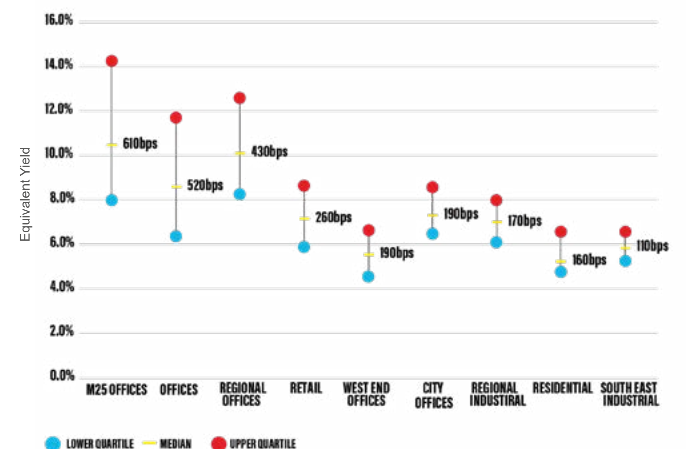
SOURCE: MSCI REAL CAPITAL ANALYTICS

Vacancy rates are pushing outwards in many out-of-town locations – with the notable exception of the particularly dynamic Oxford-Cambridge corridor – and office investment has stalled. Activity has remained relatively robust in more urban settings, particularly Central London.

For example, while leasing volumes across the whole of the UK over the past two years are 24.2% down on the 10 year average, they are just 8.5% and 9.4% down in Leeds and Birmingham city cores respectively, while in the core City of London they are not down at all.

Most importantly, a big divide has opened up in rental growth and yields between the top and bottom ends of the market, reflecting different investor appetites for both quality and location. As the graph below shows, there is a marked difference between office yields in Central London and elsewhere. Clearly, they are generally lower, but what is more striking is the lack of difference between "grade A" (upper quartile) and "grade B/C" (lower quartile) yields compared to non-urban locations.

YIELDS QUARTILE ANALYSIS



SOURCE: MSCI QUARTERLY INDEX, Q2 2024

Elsewhere, where there is a greater diversity of product and location, this spread is enormous compared to other sectors, demonstrating how concentrated value has become in the top end of this market. Investment demand for poorer office stock (in terms of location as well as quality) has been virtually non-existent, while pricing has been under extreme duress. The recently announced Permitted Development Rights for conversion to residential may change this in some locations, but the overall picture will remain. **These patterns are likely just the start of the process of polarisation and redundancy in the office sector.**

WHAT ARE THE IMPLICATIONS?

By combining the geography of "viable" refurbishment with where EPCs fail to meet the 2030 criteria, it is estimated that at least 25%–30% of the UK's office stock is likely to become permanently redundant over the next few years. These are assets where the local economic and market conditions will not support adequate refurbishment. In some of these cases there will, of course, be obvious and viable changes of use – but not always.

Furthermore, obsolescence will not be equally under threat around the country; the proportion struggling will be rather lower in Central London and other major city centres. It is vitally important that investors begin the process of understanding which buildings can be feasibly refurbished into viable offices, and which will require alternative uses, or even – taking account of concerns around embodied carbon – demolition and reconstruction.

THIS WILL INVOLVE SIGNIFICANT CHANGES IN COMMERCIAL PROPERTY INVESTMENT. ALTHOUGH REDUCED, FUNDS STILL HAVE HIGH EXPOSURE TO OFFICES, OFTEN CONCENTRATED IN PARTICULAR LOCATIONS. MANAGING THE SHIFTS OUTLINED IN THIS DOCUMENT WILL BE A CHALLENGE, BUT IN SELECTED LOCATIONS DEVELOPMENT AND INVESTMENT COULD INTENSIFY.

Above all, there will be need for investment in the existing stock (where it is in the right locations). The big question is where this capital will come from. Overseas investors may find the risks and processes too challenging, although there will local partners with expertise available for partnership. With the winding down of many Defined Benefit pension schemes – which were major investors in commercial property – domestic capital looks less plausible as a source in the short term, although local authority schemes are in some cases still looking for stock.

Defined Contribution schemes, which are now the major destination for domestic pension capital, face challenges in investing in illiquid assets given their need for flexibility. Scale is also an issue. These barriers will be overcome in time, but the gap may need to be filled by private equity and other opportunistic/value-add investors, assuming their return requirements are realistic.

Earlier in 2024, the then government reintroduced rules around Permitted Development that allow offices to be converted to residential without planning permission. It is important to emphasise that this does not apply in areas with Article 4 exemptions, which cover much of central London and many other office-heavy areas outside the capital. It will enable the easy conversion of more isolated offices, although it may be time-limited given the recent change of Government.

CONCLUSIONS

THE OFFICE IS NOT DEAD.

THERE IS STILL AN INVESTMENT CASE FOR GOOD QUALITY, WELL LOCATED OFFICES. INDEED THE MARKET MAY BE UNDER-PRICING THIS STOCK GIVEN WIDER PESSIMISM AROUND THE SECTOR.

Investors urgently need to plan ahead and consider options for individual buildings, not just those that are currently struggling with occupancy. Particular attention should be paid to the potentially time-limited options around Permitted Development Rights.

Local governments need to consider how to regenerate and repurpose town centres to either support office refurbishment where viable or change of use where not. This may include making investments themselves – perhaps through land rather than directly or with the support of their pension funds.

Planning Policy needs to be supportive of these shifts, recognising the need for change of use in some locations and an increase in the stock in others – although certain locations will need to be protected during downturns.

Government needs to plan ahead for a reducing share of business rates from offices, except in the key centres outlined above.

Government needs to confirm future EPC/MEES targets and timelines, any changes to the exemption routine, and its approach to embodied carbon. This would allow the industry, occupiers, local authorities to plan ahead with certainty.

INTRODUCTION

EVER SINCE THE POST-WAR BOOM PRODUCED THE MODERN BLOCK, OFFICES HAVE BECOME EXTRAORDINARILY IMPORTANT TO CITY AND TOWN CENTRES, AS WELL AS THE WIDER ECONOMY.

The service industries they tend to cater for have taken up an increasing share of economic activity, particularly in London. Meanwhile, the regeneration of many formerly industrial cities – notably Manchester, Birmingham, Leeds and Glasgow – has meant a reorientation towards the services sector and an increasing stock of offices in city centres.

Meanwhile office employees, who tend to be paid more than the national average, support a whole range of other businesses – from sandwich shops, pubs and restaurants through to the broader retail industry; as the think tank Centre for Cities have shown, there is a strong correlation between the volume of local office employment and retail footfall. This has been shown very starkly since the Covid-19 pandemic, with many city centre businesses – particularly in F&B – struggling with lower customer numbers, particularly on certain days of the week.

The rates paid by office occupiers are also a key part of local government finance, accounting for 20–30% of business rate income in cities such as Manchester and Leeds and over 50% in Westminster; in comparison the median local authority gets just 9% of its business rate revenue from offices.

They are also important investments for institutional investors and indirectly for large numbers of ordinary workers. Insurance companies and pension funds hold some £48bn and £43bn of direct commercial real estate, with a further £72bn held in collective investment vehicles. At least a third of this is likely to be in office assets – perhaps around £55bn. These funds may also own shares in REITs, which own a further £76bn of assets; within these, offices are by far the largest sector at £26.5bn.

And perhaps most importantly, the UK's businesses and their employees rely on the development sector to provide a stock of good quality offices in the right locations. If the conditions are not right to provide this, there could be implications for productivity, business investment and economic growth.

But as with the traditional High Street, the office has a much briefer history than many might think. Humans have carried out similar jobs in the past without offices (early City traders worked and dealt in coffee houses, for example) suggesting it is not a necessary part of "knowledge" work. The first purpose-built example was probably the Old Admiralty, constructed for the Royal Navy in 1726 – although some would point to East India House on Leadenhall Street. Either way, commercial office buildings did not become commonplace until the Victorian period.

The rise of large financial or industrial concerns led to the need to gather documents and clerical staff in one place. The first more substantial commercial office block, the Brunswick Building, appeared in Liverpool in 1841, but it was in the 1860s that purpose-built offices became a major feature in the major commercial centres, especially London –making use of changing building technology and the invention of the lift.

Clearly, some of the original reasons for the office's existence no longer apply; with digitisation, the internet and cloud technologies, document storage and physical connections to a centralised server have become increasingly unnecessary. Networking technologies and audio-visual capability in laptops mean that physical proximity is no longer as vital as it was.

Even before the dramatic impacts of the Covid-19 pandemic, these changes had led to a more mobile working environment, with laptops and hotdesking arrangements reducing the space required per employee (and the requisite costs). According to the British Council for Offices (BCO), the average density in UK offices had increased, with the amount of space per desk falling from approximately 160 sq ft per desk in 2001 to just over 100 sq ft in 2018. (The UK's offices were among the most crowded in the world; densities in neighbouring countries were generally lower, although the figures are perhaps skewed by London).

Remote and flexible working had existed before the Covid pandemic of 2020-2022, but the forced closure of offices during that period accelerated the use of these technologies and led to claims that the era of the office was over. However, workers have returned to the office, if not necessarily for the whole of the working week – a "hybrid" model has emerged.

More recently, companies have begun to encourage workers back to the office more enthusiastically, amid concerns over productivity, although this is far from universal. While attendance has increased, it still remains below pre-Covid levels, suggesting that a permanent shift to a more flexible approach has occurred.

On the other hand, policymakers and economists have raised concerns over the wider issues as agglomeration benefits are lost. There is a substantial body of academic evidence that emphasises the importance of physical proximity, "accidental" meetings and information transfers and the greater attention paid during face-to-face exchanges.

> **GIVEN THIS BACKGROUND, IT SEEMS UNLIKELY THAT THE OFFICE WILL 'DIE'. HOWEVER, THE SECTOR IS UNDERGOING UNPRECEDENTED CHANGE. IT IS BEING CHALLENGED SIMULTANEOUSLY BY TWO OTHER SEPARATE LONG-TERM TRENDS AS WELL AS SHIFTS IN WORKING PATTERNS. THE END RESULT LOOKS SET TO BE A SMALLER, HIGHER-QUALITY STOCK WHICH IS MORE CONCENTRATED IN CERTAIN LOCATIONS.**

THIS PAPER LOOKS AT DETAIL BEHIND THESE THREE MAJOR CHALLENGES:

01 ECONOMIC URBANISATION

Since well before Covid, office employment is becoming increasingly concentrated in a handful of mainly urban locations.

02 ENVIRONMENTAL OBSOLESCENCE

With legal requirements – as well as investor and occupier needs – ratcheting, a whole swathe of the office stock may never again be fit for purpose.

03 CHANGING WORKING PATTERNS

Companies that are happy with some form of hybrid approach may well choose to reduce office space and concentrate on fewer high-quality, accessible hubs.

IT THEN LOOKS AT THE EVIDENCE FOR HOW THESE ARE IMPACTING ON THE MARKET, BEFORE DISCUSSING THE IMPLICATIONS FOR INVESTORS, DEVELOPERS AND OCCUPIERS AND THE KEY QUESTIONS ABOUT THE FUTURE OF REDUNDANT OFFICE SPACE.

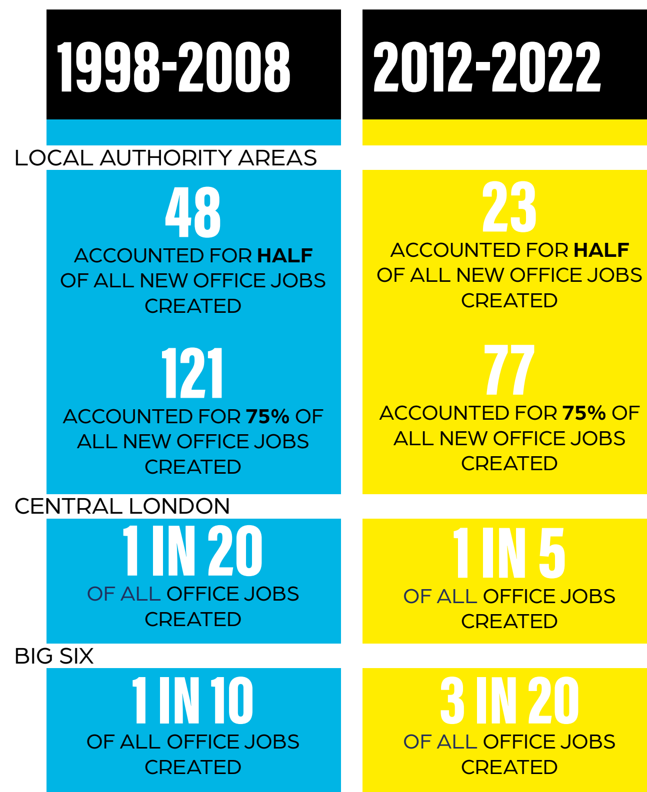
CHALLENGE ONE

THE URBANISATION OF THE ECONOMY

WHAT HAPPENED TO JOBS

Over the past decade, office job growth has become more concentrated in a handful of locations, to an extent that has not been particularly appreciated by business or policymakers, let alone the general public.

Over the 10 years leading up to the financial crisis – 1998 to 2008 – 50% of new jobs were created in some 48 Local Authority areas and 75% in 121. In contrast, over the 10 years leading up to the end for 2022, half of additional jobs were created in just 23 Local Authority areas, and the figure only rises to 77 at the 75% level.



SOURCE: MONTAGU EVANS / OXFORD ECONOMICS. ALL FIGURES ARE APPROIXMATE.

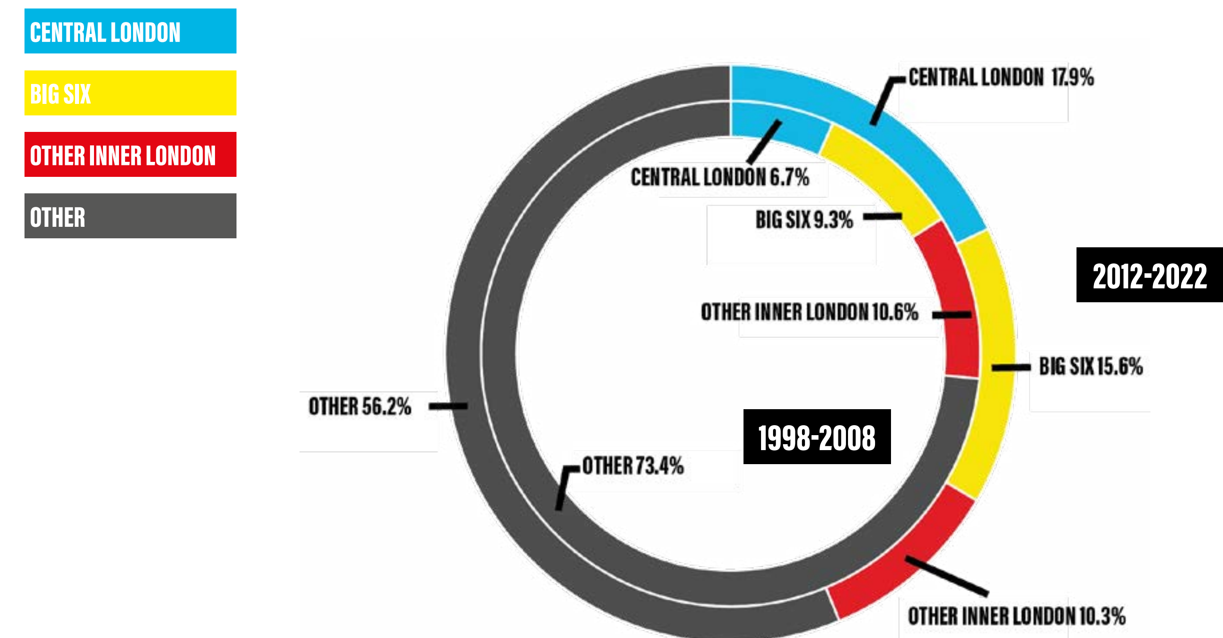
THE TOP 20 LOCAL AUTHORITY AREAS FOR OFFICE JOB CREATION OVER THE TEN YEARS TO 2022 WERE ALMOST ALL EITHER IN CENTRAL LONDON OR IN AND AROUND MANCHESTER, BIRMINGHAM, LEEDS, BRISTOL, BELFAST, GLASGOW, CAMBRIDGE, CARDIFF AND READING (AND A FEW SURROUNDING BOROUGHS).

Rewind to 1998–2008 and the picture was somewhat different. The top 20 features out-of-town locations such as West Northamptonshire, South Gloucestershire, Milton Keynes, Swindon and North Yorkshire.

Dig a bit more into the data and the differences become even more apparent. The Central London Boroughs of the City, Westminster and Camden accounted for just 6.7% of new jobs in the pre-Global Financial Crisis decade; whereas in the decade just gone, they accounted for 17.9%.

It is not just London that has been responsible for this shift, however. In the decade to 2008, the big cities outside the capital (Birmingham, Manchester, Bristol, Leeds, Edinburgh and Glasgow) accounted for just 9.3% of the net gain in employment. Many rural and "out of town" locations saw faster growth. But over the past decade that figure has risen to 15.6%. As the opposite shows, Inner London and the "Big Six" accounted for almost half of all new jobs over the past decade, compared to around a quarter during the decade leading up to the GFC. Aside from a few areas such as around Oxford and Cambridge, economic growth is becoming increasing urban and city centre focussed.

THE URBANISATION OF OFFICE EMPLOYMENT GEOGRAPHIC SHARE OF NEW JOBS CREATED



SOURCE: OXFORD ECONOMICS / MONTAGU EVANS

WHY IT HAPPENED

There are a number of potential reasons for this. It may be partly supply-led – i.e. where new offices have been provided, which has largely been in cities – arguably a result of planning and regeneration policy. Manchester's renaissance has led to very strong job growth over the past decade, whereas Birmingham city centre's performance has also improved from a lower base. (Sometimes the strength of regional centres is obscured by the underperformance of other areas of the local authority area.)

Meanwhile, Central London, especially the City, has seen more activity at the expense of other parts of Greater London and the Thames Valley, which may be a reflection of the volume of development, particularly in the tower cluster.

However, it is also a result of growing recognition among businesses about the value of cities and agglomeration economies. Attracting skilled, sometimes internationally mobile workers can be easier in amenity-rich environments which are more accessible by public transport (as well as by road).

Gathering employees near others in the same or related sectors seems to lead to productivity and innovation gains – a result of face-to-face contact and "accidental" knowledge sharing within networks.

But perhaps most decisive has been the concentration of working age population in urban areas, which has been particularly pronounced among younger generations. This trend started with the expansion of university places in the 1990s but has intensified recently, a likely combination of preferences (as urban environments have improved), demographics (there are more single people than in the past, with major life changes occurring later or not at all) and necessity (cities are where rental housing is available, given affordability issues).

A further factor may be that office space in certain locations, such as Westminster, has been protected through planning policy, whereas in more peripheral markets at least some office stock has been lost through change of use.

WHERE THE WORKERS ARE

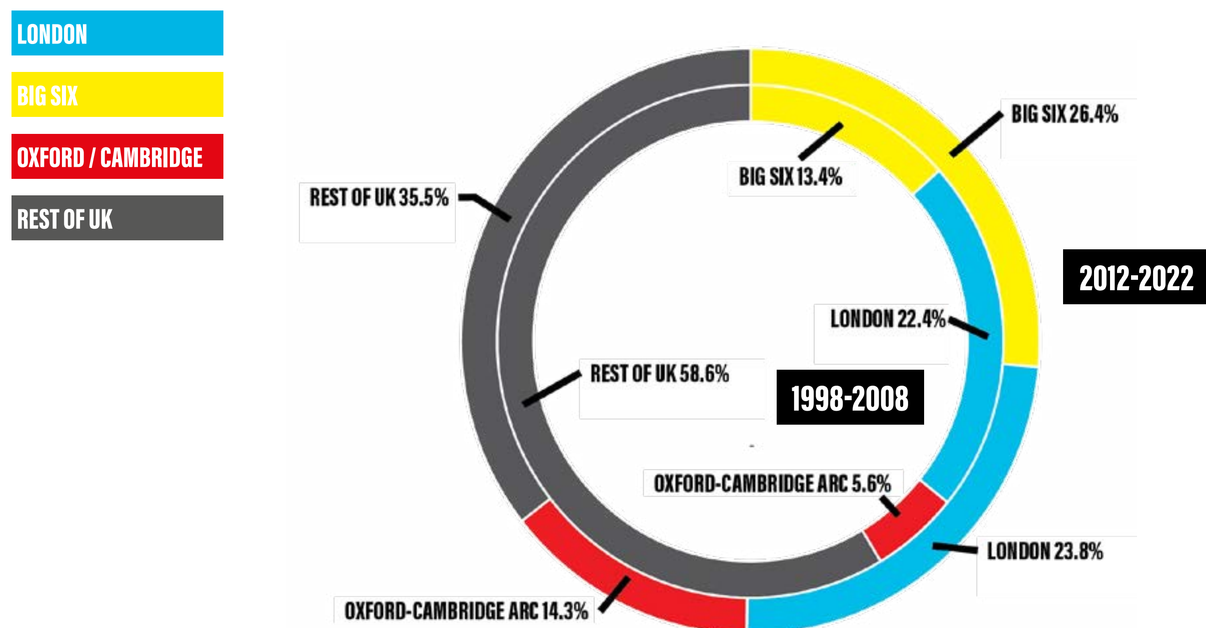
Looking at the same analysis periods the top 10 fastest growing local authority areas accounted for 14.0% of the total working age population increase in 1998-2008, a figure that had risen to 24.6% for 2012-2022. In other words, over the past decade, roughly one in every four "additional" working age people lived in one of Tower Hamlets, Birmingham, Manchester, Bristol, Glasgow, Newham, Leeds, Edinburgh, Salford and Coventry. (London's overall proportion of growth has remained steady, but it has become more concentrated, whereas some previously fast-expanding boroughs such as Westminster have seen their working age population fall).

THE MOST REMARKABLE SHIFT HAS BEEN IN THE GROWTH IN THE MAJOR CONURBATIONS OUTSIDE LONDON. OVER THE PAST DECADE, LOCAL AUTHORITIES IN THE MAIN CONURBATIONS - BIRMINGHAM, MANCHESTER, LEEDS, BRISTOL, EDINBURGH, GLASGOW, SALFORD, SANDWELL AND COVENTRY - ACCOUNTED FOR ALMOST A FIFTH OF WORKING AGE POPULATION GROWTH, 19.4%, WHEREAS IN THE DECADE LEADING UP TO THE FINANCIAL CRISIS THEY MADE UP LESS THAN A TENTH (8.6%) OF THE CHANGE.

The Greater South East (including the East of England and London) has been the one exception to this trend of urbanisation, with many suburban and rural authorities seeing strong working age population growth. Indeed, some town centres have benefitted from this given the emphasis on rail commutes, and this may help to support offices in some accessible locations.

While this is presumably partly a result of affordability issues in London (especially for families), the attractions of the Oxford-Cambridge arc are particularly apparent. Over the past decade this area has accounted for almost 15% of the national growth in working age population, whereas in the decade to 2008 this was only a little over 5%. While this is not yet discernible in the jobs analysis provided earlier in this report, the increasing economic importance of this area is evident – a result of its universities, its skilled population, and the strength of key sectors such as Life Sciences and Technology. Providing more workspace and housing here, alongside improved infrastructure, is clearly vital to enhancing UK economic growth.

WORKING AGE POPULATION GROWTH GEOGRAPHIC SPREAD, DECADE COMPARISON



SOURCE: OXFORD ECONOMICS / MONTAGU EVANS

CONCLUSIONS

WHAT IT ALL MEANS FOR OFFICES

There is an evident trend of office-type employment concentrating in a handful of urban centres (and mostly in their cores, not out of town). Given the parallel concentration in working age population, this is likely to continue, albeit with the Oxford-Cambridge arc and a few other specialised centres an exception.

This implies that the demand for offices in such locations will remain robust and could increase over time. On the other hand, occupier interest in offices in other locations is likely to become noticeably weaker.

This will not only put into question the viability of office development or refurbishment elsewhere, it is likely to create significant obsolescence problems in some locations that may previously have had a relatively vibrant office sector. In some places transformative projects or conversion to residential may address this problem, but it is unlikely to work everywhere. The polarisation of occupancy levels, capital growth and rents is set to grow.

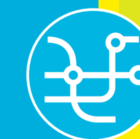
FORTUNATELY, THE RECENT REINTRODUCTION OF MORE GENERAL PERMITTED DEVELOPMENT RIGHTS AROUND OFFICE TO RESIDENTIAL CONVERSIONS MAY MAKE THIS PROCESS EASIER. IT IS IMPORTANT TO EMPHASISE THAT THESE MAY BE TIME-LIMITED, GIVEN THE RECENT CHANGE OF GOVERNMENT.

Investors with peripheral office assets may have to consider change of use, potentially making use of Permitted Development Rights.

Local authorities will have to consider how to re-orientate town centres around residents and visitors rather than employees or standard retail offers.

Councillors will have to acknowledge the need for more office space – and housing – in fast growing areas of the country, including Inner London and the Oxford-Cambridge arc.

Government will have to take into account **shifts in the contribution made to business rates by the office sector.**



Increasing employment in certain hubs implies the need for longer-term investment in more public transport

CHALLENGE TWO

ENVIRONMENTAL AND DESIGN OBSOLESCENCE

INTRODUCTION

The single biggest quantifiable threat to many offices is their poor environmental performance. Part of this is driven directly by legislation.

Under Minimum Energy Efficiency Standards (MEES) legislation, the UK Government has already made it unlawful to let buildings with an Environmental Performance Certificate (EPC) rating of F or G. It is consulting on making B the minimum permissible rating by 2030, with a possible intermediate step of C in 2027.

Given some of the issues around EPCs – namely their lack of reliability and questions around their relationship with actual building performance – the Government has also previously considered introducing an alternative measurement system. This would likely be along similar lines to the Australian NABERS certification, which involves measuring actual operational carbon emissions and energy efficiency. This would be unlikely to make the problem less significant.

At the same time, businesses' own requirements are becoming more stringent. Many have their own plans to reduce carbon emissions based around either net zero or science-based targets, which mean it will be hard for them to own, stay or move to poorly performing buildings. Even if the rate of change slows, or government goalposts are shifted, the direction of travel is apparent - which means that the poorer the environmental rating of an asset, the less attractive it is as an investment.

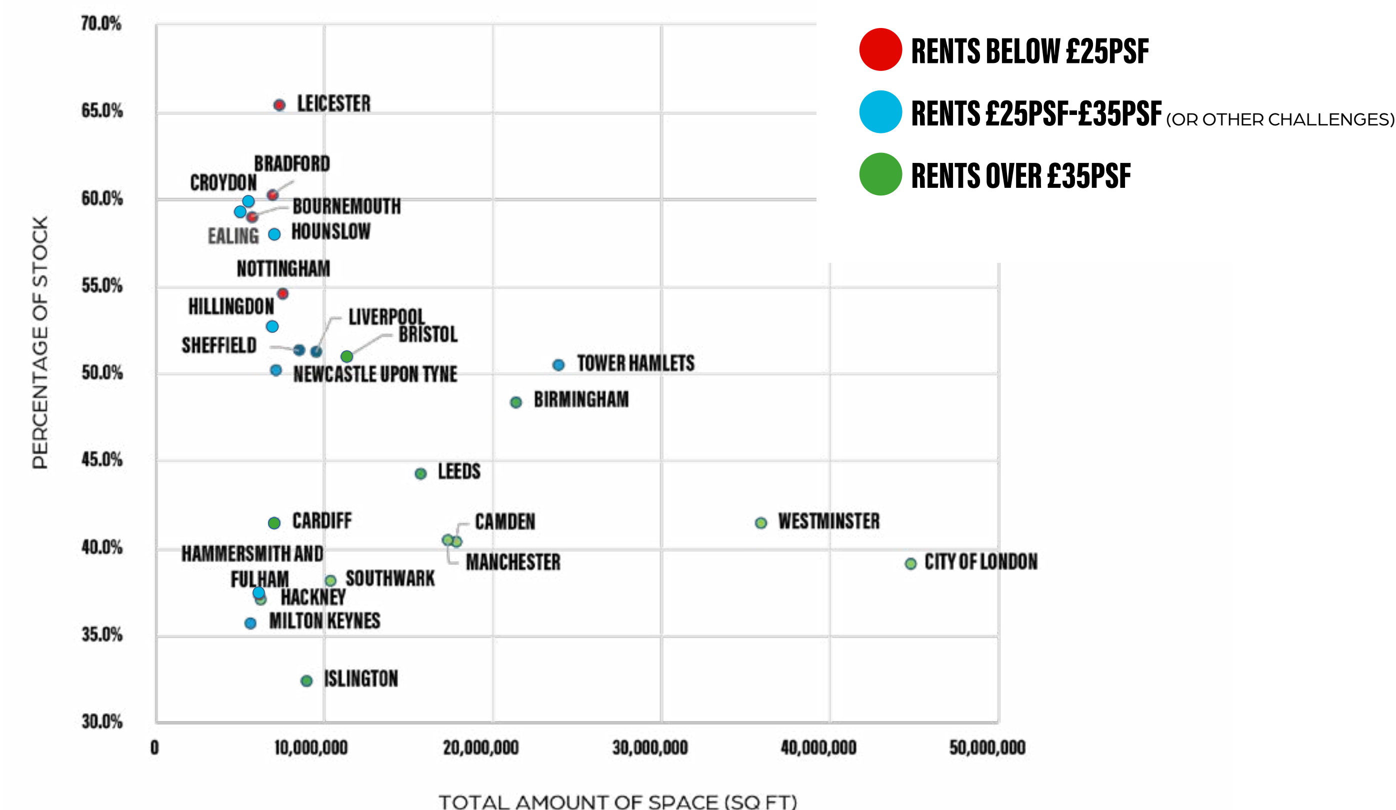
Furthermore occupiers know that younger employees are increasingly environmentally aware and prefer to work (and stay) at companies that demonstrate their sustainability credentials – and what is more public and obvious than their premises? This is part of a wider trend in which offices and workplace design support corporate branding as well as recruitment and retention. Investors, who must take a longer term view, are also critically aware of these factors and increasingly see poor environmental performance as a major risk, whatever the regulatory system.

Until more reliable measurement systems are in place, EPCs remain both the only real comprehensive source of data, and as they are legally binding, they are of great importance to the office market.

There is a huge geographic variation, which is partly a result of the underlying distribution of offices (which are highly concentrated in London and a few other centres) but also the longer history of where these buildings have been constructed and how.

It is also difficult to generalise about how much it will cost to retrofit office buildings, as it varies significantly. However, there are tools emerging such as our own **ME:EStimate**, which provide rapid, reasonable indicative estimates of retrofit costs. Such estimates can help inform early-stage thinking on refurbishment versus change of use.

OFFICE EPCS WITH D OR BELOW MAJOR MARKETS



SOURCE: MONTAGU EVANS / MHCLG

WHERE THE PROBLEMS ARE

The chart above shows the 20 biggest local authority office markets in England & Wales, measured by both the amount and the percent of workspace which would fail to meet the provisional 2027 criteria that only EPCs of A-C would be permissible for letting[1]. The colour of the dot provides an indication whether the rents and other market conditions are likely to support development, at least in certain locations within the area.

Birmingham, Leeds and Bristol have somewhat more of a problem in percentage terms, although over the cycle these markets should offer at least some opportunities for refurbishment. Tower Hamlets and some West London boroughs may have more specific problems given high vacancy levels. But perhaps more of a concern are the cities in the top left hand corner – all of which have reasonably large office stocks, of which 50% or more is potentially "non-compliant".

AS CAN BE SEEN, THE MOST SIGNIFICANT PROBLEMS IN TERMS OF QUANTUM ARE IN LONDON, PARTICULARLY IN THE CITY AND WESTMINSTER, ALTHOUGH IN PERCENTAGE TERMS THESE ARE FAR FROM THE WORST - AROUND 60% OF BUILDINGS WOULD ALREADY PASS THE LIKELY 2027 CRITERIA OF C OR ABOVE.

1The data is not comprehensive as some owners can opt for confidentiality, but looking at the total floorspace we estimate that somewhere between 60% and 80% of EPCs are included, which should allow comparative analysis. It does also include some light industrial premises following the 2020 changes of the use class order, but these are unlikely to significantly change the overall picture. Not all EPCs will be up to date but they will still be useful in giving an idea of the comparative scale of the issue.

Rents in Liverpool, Nottingham, Sheffield and Bradford (and perhaps Newcastle too) are generally too low to enable large-scale refurbishment. This is a problem as the cities do have (at least in some cases) some economic vibrancy. Vacancy rates are actually not particularly high in these cities, which suggests that the lack of rental evidence (and recent development) may be the underlying problem, not a real lack of demand for office space.

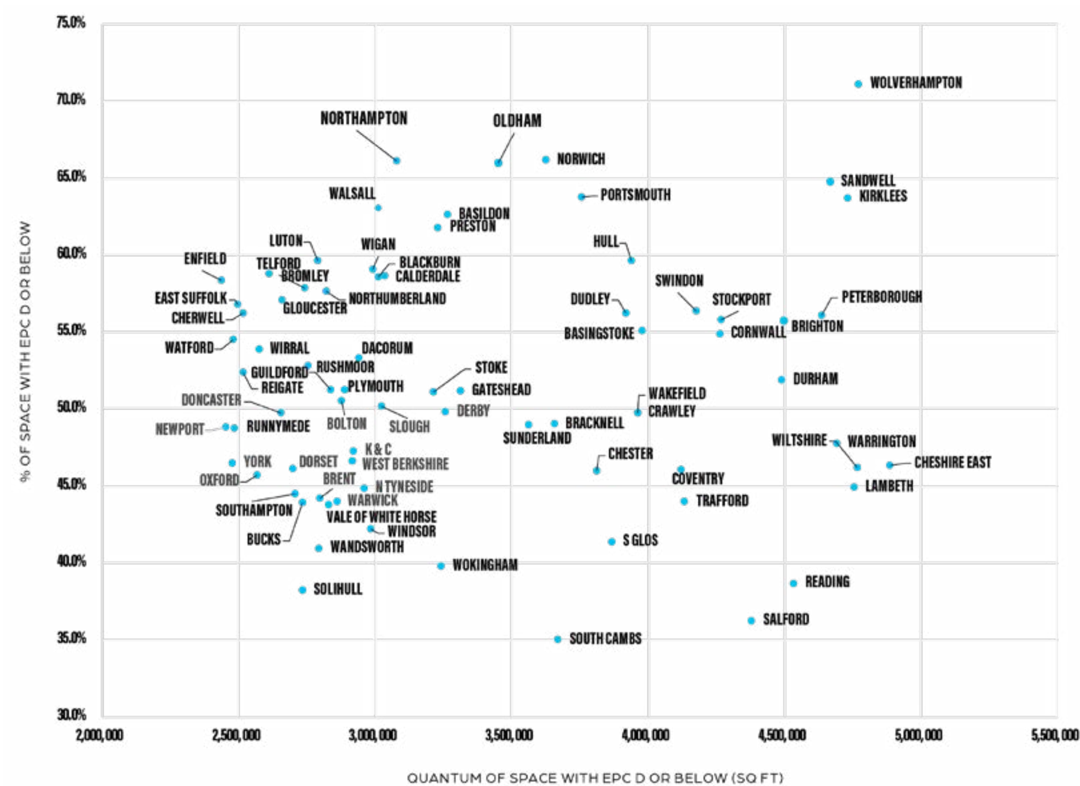
This points to the need for carefully targeted local intervention by the public sector, or perhaps for local occupiers to work more closely with landlords The alternative is a vicious circle in which a lack of appropriate stock degrades the city's attractiveness, which in turn puts downward pressure on rents, making it harder to provide new or refurbished offices.
Applying a similar approach to the next 75 local authorities produces the chart below. A similar pattern emerges.

In contrast, there is also a cluster of markets at the bottom of the chart with much less of a problem. They are in economically buoyant parts of the country, with significant recent development (explaining relatively good environmental performance of the stock). These include Solihull, Wokingham, South Cambridgeshire (where a lot of "Cambridge"office stock has been built), as well as Salford, effectively an extension of Manchester City Centre.

But the most serious problems are found in the top left of the chart, where over 60% of the stock is poorly performing. These are largely "struggling towns" such as Wolverhampton and Portsmouth, but more prosperous centres such as Norwich and Northampton are also present.

Unfortunately, rents and market conditions in many of these locations are unlikely to support extensive refurbishment although in some cases this may reflect a lack of rental evidence. This is a potentially serious social, economic and political problem, adding to the existing issues around, for example, retail vacancy.

OFFICE EPCS WITH D OR BELOW SMALLER MARKETS



SOURCE: MHCLG / NATIONAL STATISTICS

WHILE THIS ANALYSIS HAS FOCUSSED ON THE REGULATORY AND LEGAL ASPECTS OF ENVIRONMENTAL SUSTAINABILITY, THIS SHOULD NOT IMPLY THAT THIS IS THE ONLY DRIVER. EQUALLY IMPORTANT IS OCCUPIERS' INCREASING INSISTENCE ON OFFICES THAT MEET THEIR OWN CARBON-REDUCTION TARGETS. AND INVESTORS' GREATER UNDERSTANDING OF ENVIRONMENTAL RISK.

In addition to the environmental problems, there are also wider redundancy issues. Surveys tend to show that for some time office design has become more central to the choice of premises and wider business decisions.

Rather than simply a cost that cannot be avoided, some see them as investments that can help improve productivity, innovation, retention and recruitment. This has put a greater premium on new offices – perhaps also newly refurbished offices with character – as well as the location and the amenities either provided on-site or nearby.

As many older offices cannot provide this, their viability has become increasingly challenged. This increasing focus on best-in-class workspace has been intensified by the experience of Covid-19 and its aftermath. Given that EPCs tend to vary mostly depending on age (and are probably also to some extent a measure of quality), the environmental and "design" redundancy aspects may be very closely related.

If offices are becoming obsolescent more quickly, it is important for landlords to develop strong relationships with their tenants, to consider how services and refurbishments can keep them in situ, and how they can move occupiers around their estate as they grow or their leases break or end. Together with shorter lease terms, this 'accelerated obsolescence' means that void risks (and refurbishment cost shocks) are becoming more of an issue earlier in asset life cycles.

CONCLUSIONS

WHAT IT ALL MEANS FOR OFFICES

Investors with substandard offices should assess retrofit need and consider whether local market conditions justify refurbishment or whether change of use is more appropriate.

Local Authorities and Planners need to consider how to rejuvenate office stock (if appropriate) or how to enable change of use as part of wider regeneration plans. They should also consider how this can support more viable office use by providing the amenities and vibrancy that encourage workers to come to the office. They could also engage with local landlords to ensure awareness of the issue and available solutions and to proactively address problems in their own stock – while calling for more clarity from the government.

Occupiers of substandard buildings, particularly in cities that are economically vibrant but lack active property markets, may need to work more closely with the private sector and local authorities if they wish to see more modern buildings emerge.

Landlords need to consider their service offer to, and relationships with, tenants to keep them as loyal customers as obsolescence accelerates and void risks loom earlier. Tools such as green leases could help formalise collaboration.

The Government needs to confirm future EPC targets and any changes to the exemption outline so the industry can plan ahead with confidence.

CHALLENGE THREE

HYBRID AND REMOTE WORKING

INTRODUCTION

For some time – since widespread high-speed broadband at least – it has not been necessary to be in an office to carry out productive office-type work. The emergence of networking and video conferencing had made this even more feasible. However, it took the enforced conditions of the Covid-19 pandemic lockdowns to introduce it en masse to the workforce. Initially, many employers found this satisfactory and did not note any productivity losses, with some executives arguing that the "office was dead" and firms could cut costs by jettisoning office space.

With the end of Covid-19 restrictions remote work has continued to be more popular than before, although many senior managers began to express concerns over effectiveness some time ago and have tried to bring staff back to the office. The most popular route has been towards a 'hybrid model' where 2-3 days in an office are combined with 2-3 days at home.

However more recently some leaders have called for a greater return to the office against the background of more general issues around national productivity. There is extensive academic evidence showing the benefit of physical agglomeration, face-to-face contact and informal information exchange to innovation and productivity. On the other hand, the US, with perhaps the highest WFH tendency, has seen very fast productivity growth since the pandemic.

THE RETURN TO THE OFFICE

At present, according to figures from third parties such as Remit Consulting – which monitors a sample of buildings – and proxy data such as transport patterns, peak office attendance is somewhere between 70% and 80% of the pre-Covid level on the most popular days of the week, i.e. from Tuesday to Thursday. However, it is closer to 50% on Mondays and as low as 20% on Fridays.

As the graph below shows, while occupancy rose steadily from 2021 to 2023, there has been less of an observable upward trend recently. This suggests that this 'hybrid' pattern is here to stay, although it may change if the currently tight employment market loosens and the call for more office-based working gains traction.

UK OFFICE OCCUPANCY, 4 WEEK ROLLING AVERAGE

SOURCE: REMIT CONSULTING

One intermediate step may be to try to spread attendance more evenly over several days so that offices remain attractively busy throughout the week. (It is worth noting that surveys generally show people enjoying, overall, being in the office, albeit not always keen to return for five days a week. The major deterrent is the extent to which people dislike their commute.)

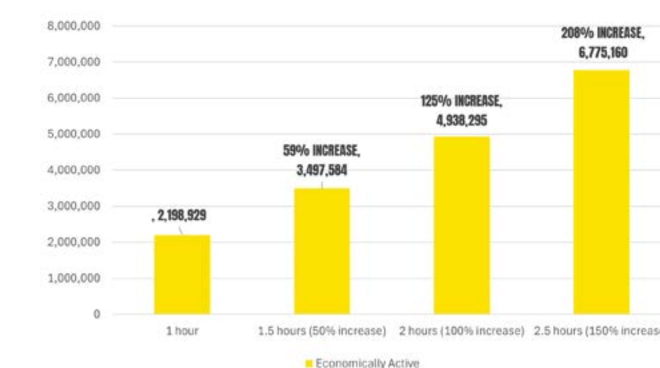
However, if attendance does remain below the pre-Covid level, then it does imply lower aggregate demand for office space. Companies may choose to centralise in the most accessible locations, where they can invest more heavily a more attractive workplace (which could benefit the brand as well as improving staff morale) which might incentivise staff attendance particularly among those with longer or more difficult commutes.

IN SHORT, WHILE OVERALL DEMAND FOR OFFICE SPACE MAY FALL, THE DEMAND IN MAJOR OFFICE CENTRES SUCH AS THE CITY OF LONDON MAY INCREASE.

There is another aspect to hybrid working that may further intensify this phenomenon. Three-day-working (for example) might encourage more people who live further away from centres such as London to enter its labour market. This would further increase the benefits of having a centrally located office, as the potential workforce is larger than before hybrid working become common. (This is also true, of course, if the existing workforce has moved further out in comparison to the period before Covid).

Using Bank Station in the City of London as an example, if 120 minutes rather than 60 minutes public transport commute is considered feasible if only required two or three times per week, the potential available workforce (i.e. adults of below retirement age) moves from 5.8m to 12.8m, an increase of 123%.

BANK STATION
POTENTIAL WORKFORCE BY COMMUTE



SOURCE: MONTAGU EVANS / STOREPOINTGEO

Some companies may find this more important than others, depending on whether they struggle to find skilled workers in certain areas. At the moment, it seems difficult to generalise as approaches vary widely, depending on job role, industry, and indeed individual companies' cultures and leadership.

In summary, while office attendance may continue to increase slowly, it seems unlikely to revert to the situation before the pandemic. At the moment it seems to be stabilising at around 75-80%, averaged over the week. This does imply that some companies could see opportunities for space saving, consolidation and/or concentration. This would further increase demand for central locations at the expense of peripheral markets.

CONCLUSIONS

WHAT IT ALL MEANS FOR OFFICES

Investors need to ensure that their office portfolios are in the most accessible locations, and have strong environmental and design credentials.

Occupiers need to be aware of the importance of building and fit-out quality (as well as accessibility) if they want to encourage their staff to return to the office

Local Authorities and Planners need to consider how shifting transport patterns are changing how their area functions. Some developers are noting a preference for locations near stations, as commuters do not want a second stage within their morning journey.

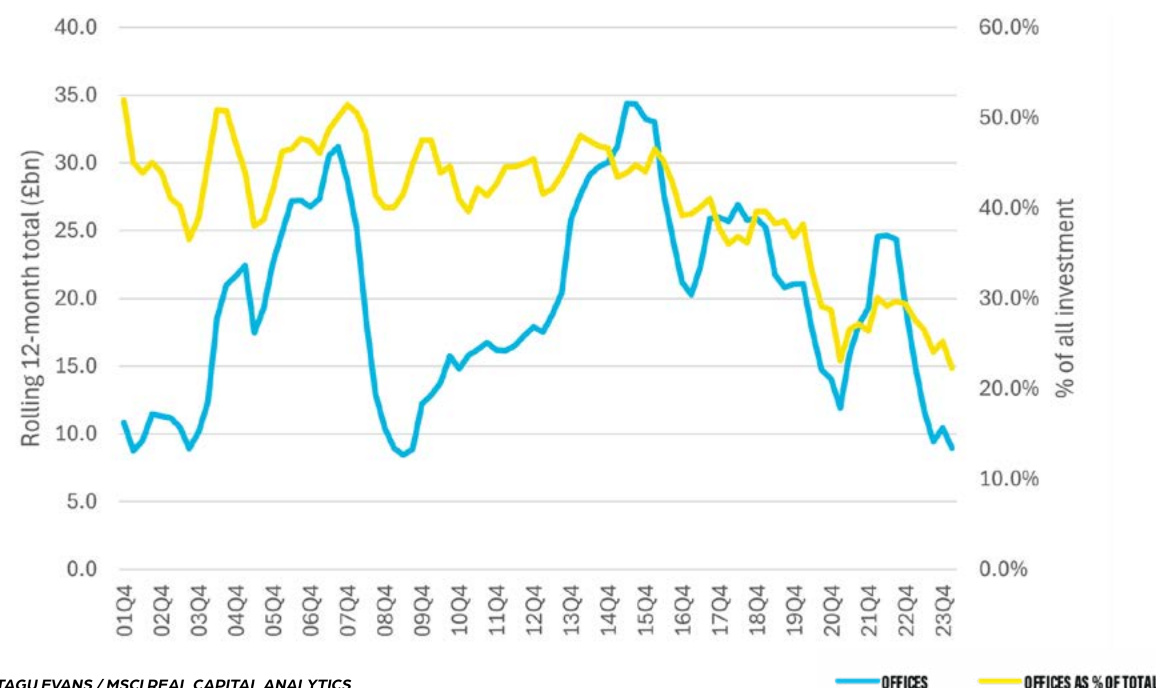
WHAT IS...
THE MARKET EVIDENCE?

These problems are already evident in office market metrics. Offices typically accounted for 40–50% of UK investment volumes between 2001 and 2015/16. This figure has been in consistent decline for almost a decade now and has recently been closer to 25–30%.The increasing attractiveness of sectors such as residential and industrial may also be factors, given the backdrop of tight pricing.

HOWEVER MORE RECENTLY IT IS LIKELY TO BE RELATED TO GLOBAL CONCERNS OVER THE FUTURE OF OFFICES DRIVEN PRIMARILY BY THE US EXPERIENCE. AND WHILE THE UK'S OFFICE MARKET APPEARS STRONGER THAN IN MANY OTHER GEOGRAPHIES, INVESTOR DEMAND HAS ALSO BEEN IMPACTED BY GLOBAL SENTIMENT. BETWEEN 2001 AND AROUND 2015/16 OFFICES ALMOST ALWAYS ACCOUNTED FOR 40-50% OF UK INVESTMENT VOLUMES. THIS FIGURE HAS BEEN IN CONSISTENT DECLINE FOR THE PAST FEW YEARS AND HAS RECENTLY BEEN CLOSER TO 25-30%.

Leasing has not been as badly hit as investment, with volumes across the whole of the UK 36% below the 10-year average as of the year to Q2 2024. But what is perhaps more telling is how different markets have performed. Activity in the City Core was only 5% below the long-term average, while in Outer London it was 37% below. And while the major city cores outside London have seen a 38% fall, their hinterlands are some 50% below long-term trends.

UK OFFICE INVESTMENT TOTAL AND AS % OF ALL INVESTMENT



SOURCE: MONTAGU EVANS / MSCI REAL CAPITAL ANALYTICS

In short, the figures do indeed ,as predicted, point towards a lower aggregate demand for offices, but with some locations seeing robust or even stronger activity than before the pandemic. This is particularly the case in Central London. Equally, while the big cities outside London have seemed weaker recently, the gap between their cores and their out-of-town markets appears to have increased. The real challenge, though, is how second-tier cities and towns cope with this new phase of economic urbanisation.

The stock itself has already begun to respond to these trends. As can be seen below, the fastest growing markets over the past five years are London and the other big cities, as well as Cambridge. Meanwhile, the markets which have seen the most significant contraction are largely the out-of-town markets around London, in the Home Counties, except for Aberdeen, which has particular issues given its heavy dependence on the oil & gas markets.

This geographic polarisation is increasingly apparent in market statistics. The highest vacancy rates – at 20% or more – are generally in towns or out-of-town locations such as Swindon, Maidenhead and Woking as well as non-central London office markets such as Hammersmith, Docklands and Chiswick. City centres such as Manchester, Birmingham and Bristol do also have relatively high vacancy rates - just behind these areas - but this probably reflects both recent development and a focus on demand on the central core rather than the immediate periphery.

Vacancy rates can be misleading, especially if a lot of space is under construction, but in parts of the Thames Valley around 6% of buildings (weighted by size) have been completely vacant for more than a year, whereas Oxford, Cambridge and Milton Keynes generally have virtually zero in this category. This is likely a combination of demand and difficulties related to planning and infrastructure in building here – meaning the supply response is notably more subdued than in cities such as Manchester or Birmingham.

FASTEST GROWING MARKETS BY INCREASE IN FLOORSPACE 2018-2023

Market	Increase
LONDON	11.2M SQ FT
MANCHESTER	3.5M SQ FT
LEEDS	1.3M SQ FT
BIRMINGHAM	1.2M SQ FT
CAMBRIDGE	1.2M SQ FT

FASTEST SHRINKING MARKETS BY DECREASE IN FLOORSPACE 2018-2023

Market	Decrease
ABERDEEN	-0.37M SQ FT
BERKSHIRE & NORTH HAMPSHIRE	-0.36M SQ FT
SURREY	-0.38M SQ FT
SWINDON	-0.24M SQ FT
ESSEX	-0.18M SQ FT

SOURCE: MONTAGU EVANS / COSTAR

PRICE SIGNALS

These impacts are also showing up strongly in pricing signals. As the graph of the MSCI Quarterly Property Index below shows, offices have been the worst performing sector (in terms of total returns) over both the 1- and the 3-year period. Over the past year alone all office sectors except Central London have seen negative returns of 10% or more, and even on a 5-year period it is only some retail sectors that perform more poorly.

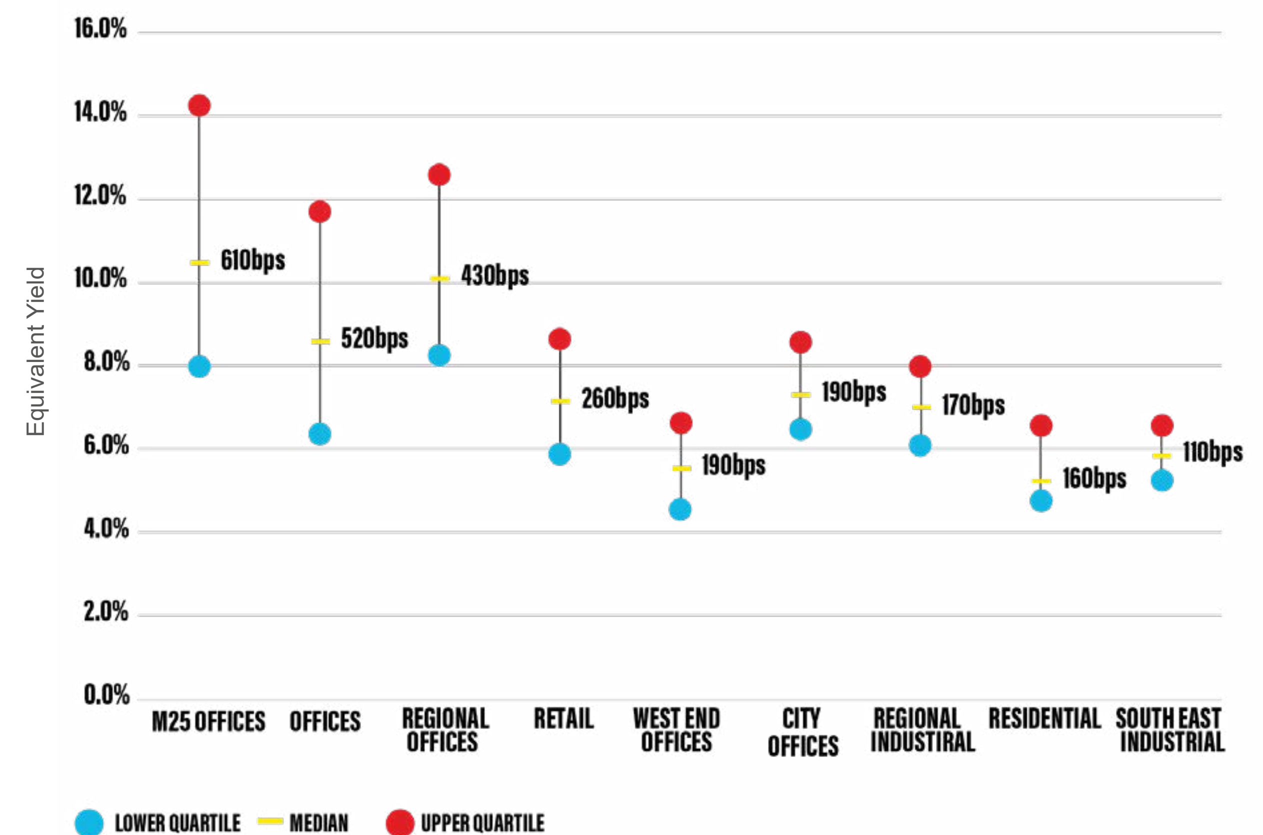
TOTAL RETURNS, MSCI UK QUARTERLY INDEX

SOURCE: MSCI, QUARTERLY INDEX Q2 2024

HOWEVER, THIS HIDES HIGHLY DIFFERENTIATED PERFORMANCE IN DIFFERENT PARTS OF THE MARKET. MSCI DIVIDES ITS EQUIVALENT YIELDS INTO QUARTILES; IN OTHER WORDS, IF BUILDING WERE LINED UP IN ORDER OF THE AMOUNT OF RENTAL GROWTH THEY HAVE EXPERIENCED, WE CAN GET AN IDEA OF WHAT STANDS AT THE QUARTER-WAY POINT AND THE THREE-QUARTER-WAY POINT (AS WELL AS IN THE MIDDLE). THIS PROVIDES A GOOD PROXY FOR HOW THE "TOP" AND "BOTTOM" ENDS OF THE MARKET ARE PERFORMING. THE RESULTS ARE SHOWN OVERLEAF WITH THE FIGURES INDICATING THE SPREAD BETWEEN THE UPPER AND LOWER QUARTILES (OR BETWEEN "GRADE A" AND "GRADE B").

Overall, 540bps, the spread for offices is over twice as high as the next highest, retail (260bps) indicating quite how polarised current conditions are in this sector. However, looking just at Central London Offices, the spread is much lower, at 190-220bps, more comparable to other sectors. Offices outside the South East show a strong divergence too, at 430bps, but it is "South East Offices" (the MSCI "Inner South East and East" segment) which has the highest, at 690bps. This more than anything out demonstrates how location and quality are combining in this polarisation process.

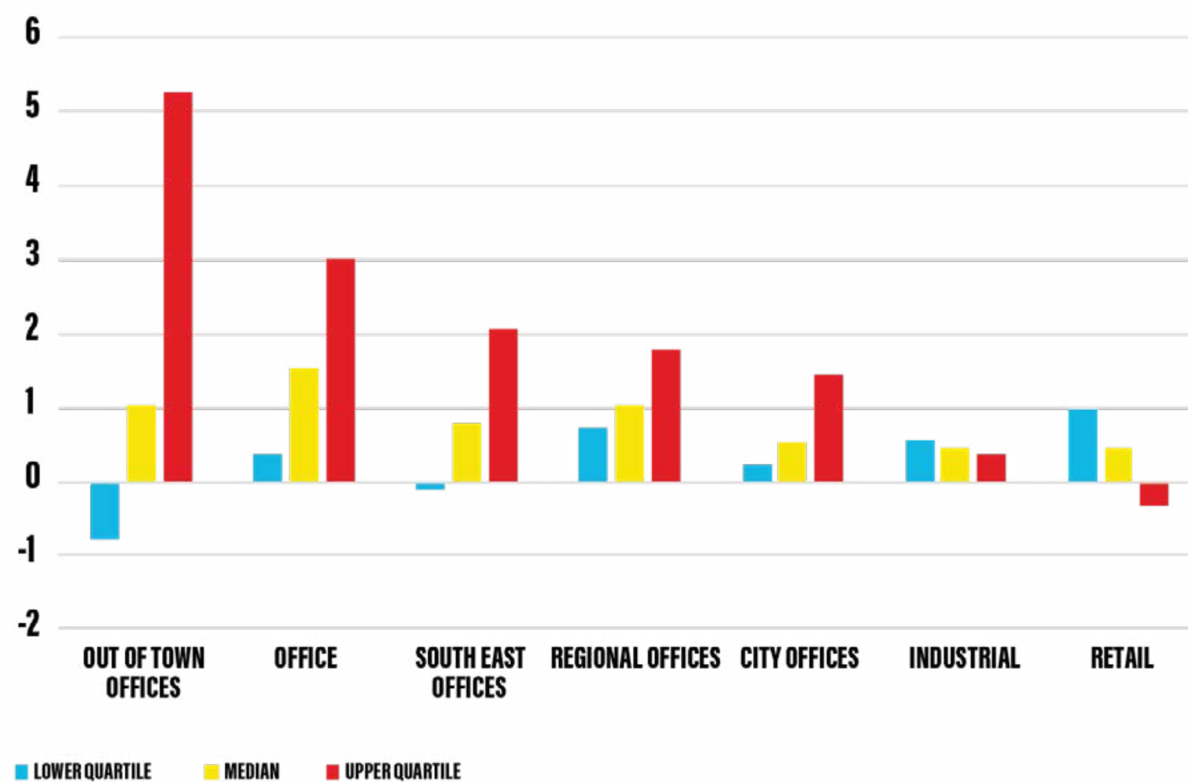
YIELDS QUARTILE ANALYSIS



SOURCE: MSCI, QUARTERLY INDEX Q2 2024

This gap has intensified strongly over the past few years. The chart below shows how yields moved over the three years to December 2023, using the same quartile analysis as before. For retail and industrial, it is the lowest yielding properties that have seen the biggest shifts, reflecting a "depolarisation". In contrast, for offices, it is the highest yielding properties (presumably the poorest quality assets) which have moved the most – 300 basis points overall. This shift is also much higher for South East offices.

YIELD SHIFT. BASIS POINTS THREE YEARS TO Q1 2024



SOURCE: MSCI, QUARTERLY INDEX Q2 2024

Together, this demonstrates that high-quality, well-located offices are still a very attractive investment. Indeed they may now be underpriced given the negativity around the sector globally. This is of course partly influenced by experiences in the United States, where vacancy rates were historically higher, the office stock somewhat older, and the return to the office, so far at least, rather less marked. On the other hand, it does also show that there are parts of the office market which remain in serious trouble in the longer term.

PERMITTED DEVELOPMENT RIGHTS

EARLIER IN THE YEAR, THE PREVIOUS GOVERNMENT ANNOUNCED CHANGES TO PDR RIGHTS THAT REMOVED THE VACANCY REQUIREMENTS AND MAXIMUM 1,500 SQ M (15,000 SQ FT) FLOORSPACE LIMIT.

This means that many office buildings can be converted to residential use without planning permission. Such PDR rights, where applicable, are subject to Prior Approval from the local planning authority in which matters such as transport, contamination, flood risk, noise impacts, daylight, and fire safety are material considerations. S106 obligations unrelated to these material considerations cannot be sought , including affordable housing – a factor that often makes schemes unviable.

This will doubtlessly speed the conversion of some stock, but there are some constraints. Firstly, many areas with significant office stock – much of Central London and the cores of the most significant cities outside the capital – are covered by Article 4 exceptions which prevent PDR. Secondly, conversions still have to pass building regulations and many may not be easily made suitable for residential use. Thirdly, the new government may change this regulation so there may only be a narrow window. Nevertheless it is a route for owners to consider, but may need to be done fairly quickly.

WHAT ARE THE IMPLICATIONS?

AND WHAT CAN BE DONE?

THE PATTERNS OUTLINED IN THIS REPORT ARE LIKELY JUST THE START OF THE PROCESS OF POLARISATION AND REDUNDANCY IN THE OFFICE MARKET. BY COMBINING THE ASSESSMENT OF "VIABLE" REFURBISHMENT AND WHERE EPCs FAIL TO MEET THE 2030 CRITERIA, IT IS ESTIMATED THAT AT LEAST 25%-30% OF THE UK'S OFFICE STOCK IS LIKELY TO BECOME PERMANENTLY OBSOLETE OVER THE NEXT FEW YEARS.

These are assets where the local economic and market conditions will not support adequate refurbishment. In some of these cases there will, of course, be obvious and viable changes of use – but not always. Furthermore, this will not be equally distributed around the country; the figure will rather lower in Central London and other major cities although there may be particular areas with issues, a reflection of earlier office booms and trends.

It is vitally important that investors begin the process of understanding which buildings can be feasibly refurbished into viable offices, and which will require alternative uses. Residential may well be the most obvious option, especially given the recent changes to Permitted Development Rights, although this may in some cases be prevented by building suitability or local authority level exceptions to PDR.

Other options include hotels, serviced apartments, purpose-built student accommodation, co-living, galleries or cultural facilities, and perhaps in some locations some form of flexible space (all of which will require planning consent). It is hard not to come to the conclusion that some offices will not be reusable in any form and will require demolition and rebuilding – despite understandable concerns around embodied carbon.

In some cases, reuse may be possible but only with close partnership with the local authority and other stakeholders as part of a well thought-through and comprehensive regeneration programme.

This will involve significant changes in the commercial property market as investors' exposure to offices - both equity and debt - will continue to fall from still-significant levels. There is scope in the longer term, however, for investment in certain locations to grow as employment office space and the associated will continue to expand in hubs. Above all, there will be need for investment in the existing stock (where it is in the right locations). The big question is where this capital will come from.

Overseas investors may find the risks and process too challenging, although there will be local partners with expertise available for partnership. With the winding down of many Defined Benefit pension schemes, domestic capital looks less plausible in the short term, although local authority pension schemes are in some cases still looking for stock. The growing Defined Contribution area has perhaps the greatest potential, although it may be some years before property becomes a viable target.

THE OFFICE IS CERTAINLY NOT DEAD.

There is still a significant investment case for good quality, well located offices, or assets convertible into them. Indeed the market may be under-pricing this stock given wider global pessimism around the sector, meaning the case for interest will grow as the UK-specific conditions are better understood. For some other locations, as pricing adjusts and concern over embodied carbon continues to mount, adaptive re-use will become easier, although for some buildings redevelopment may be the only option.

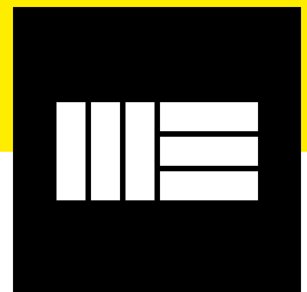
Investors urgently need to plan ahead and consider options for individual buildings, not just those that are currently struggling with occupancy.

Local governments need to consider how to regenerate and repurpose town centres to support either office refurbishment where viable or change of use where not.

Planning Policy needs to be supportive of these shifts, although there will perhaps be an even greater need to protect the most obvious office locations during cyclical downturns.

Government needs to plan for a reducing share of business rates from offices, except in the key centres outlined above.

The legislation for EPCs, MEES and embodied/whole-life carbon needs to be confirmed so that the industry can plan ahead.



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