RESEARCH

UK MARKET OUTLOOK JANUARY 2014

Knight Frank

Offices – where to find value in 2014

Last month in this note we predicted that UK industrial real estate would start to challenge offices for pole position in the commercial property market, based on IPD performance. The latest figures support that view. The November IPD capital value indices showed the industrial index rising 1.6% month-on-month, overtaking offices on 1.4% growth.

This is encouraging news for industrial landlords, although one month does not make a trend. Offices have put in a solid performance for quite some time, and it is no longer the case that central London is supporting the figures. In recent months outer London and South East offices have delivered solid IPD figures.

This is because the office sector has enjoyed a renaissance lately, thanks to changing work patterns. In the UK the density of office space per worker has dropped as low as is realistic, while the new wave of tech firms driving the economy value offices and see them as places that allow staff to mix and generate new ideas.

With services accounting for around three quarters of UK GDP, we believe offices should be a key target for property investors in the new cycle. While retail is also part of services GDP, our expectation is that the economy will rely less on the consumer and more on the corporate world to drive growth, which favours offices.

Consequently, we set out below our tips for office investment in 2014.

1. **The bigger cities will offer the best returns.** Britain's cities grew up to a Victorian economic pattern whereby the big conurbations were ringed by smaller, feeder cities, which provided resources or sub-production to the mother city. The big centres have successfully re-invented themselves as creative, technology and service industry hubs. The feeder cities relied too much in recent decades on call centres and the public sector, so an embattled consumer and government cuts have bitten hard. In London the upswing is at an established stage, but there is still the opportunity to catch more of the cycle in Birmingham, Leeds, Manchester, and the South East.

The market in a minute

Investment volume for 2013 tops £48.5 bn, up 45% on 2012.*

IPD capital growth index rises for seventh month in a row in November.

Offices saw the highest capital growth in 2013, up 5.08% on a 12 month basis.**

Retail finished the year with a fall in capital values, down 0.53%.

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** Based on Property Data figures*
*** Based on the IPD monthly capital growth index*

JAMES ROBERTS
Head of Commercial Research

"Offices have put in a solid performance for quite some time, and it is no longer the case that central London is supporting the figures."

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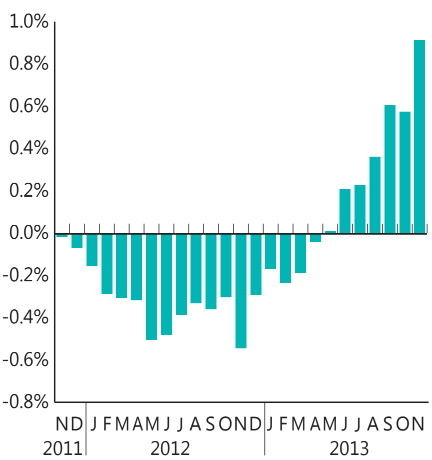
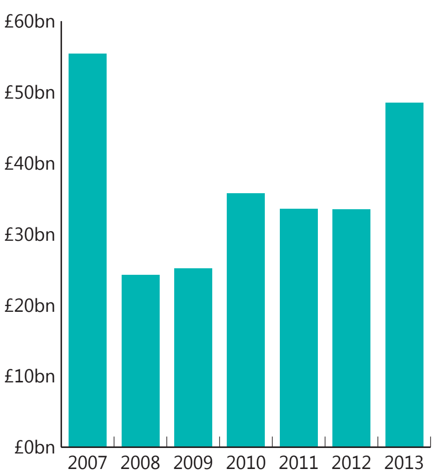
FIGURE 1
IPD capital growth index
Month-on-month change



Source: IPD

FIGURE 2
UK investment volume



Source: Property Data

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"In the UK densities are so low that the arrival of new working areas like break-out space, and even exercise areas, means that space per worker could start to rise."

2. **2014 will be the year for edge of CBD locations.** In London and New York the office sub-markets that have performed strongest lately have not been the traditional CBD cores, but gentrifying fringe areas. This reflects the growing importance of new technology and creative industry companies in the office market, who often prefer a mixed-use and a trendy environment. Also, up to now the enterprise zones have made little impact, but a rising economic tide will bring them into focus, and we expect the more successful ones to be those in edge of CBD locations in the regional cities.

3. **Look out for communal offices.** Another trend emerging in the Big Apple which we may see appear on this side of the Atlantic is the rise of communal offices. WeWork, a US firm that operates in this area, has been expanding steadily in New York in recent years. These offices sit somewhere between a serviced office and a tech incubator, where entrepreneurs rent desk space and work surrounded by people running other businesses. This could offer new life to older buildings in fringe locations.

4. **Average space per office worker will start to rise.** When speaking to researchers in Knight Frank's international network we often hear comments about "cutting space per worker down to 175 sq ft". In the UK densities are so low (typically 100-125 sq ft per worker) that the arrival of new working areas like break-out space, brain storming rooms, and even exercise areas, means that for the first time in decades space per worker could start to rise. The size of the individual's work station is unlikely to increase, but increasingly the office is less about the desk and more about creating new spaces for colleagues to interact. This is where we will see growth coming through.

5. **Expect grade B supply to come under pressure in city centres.** While demand is traditionally strongest for grade A early in the cycle, we see start-up businesses playing a bigger role in this cycle. Inevitably the cheapest options appeal to start-ups, and the rise of wifi and cloud computing make grade B more practical than was the case in previous cycles. Also, with the housing market improving and planning controls relaxed, we expect developers to target town house type office buildings on the margins of CBDs for conversion to residential.

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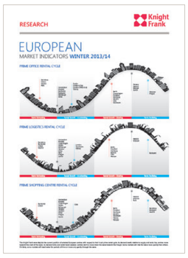

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