



## The Development Cycle: A Catalyst for Rental Recovery in London?

Kevin McCauley, Director, Central London Research and Consulting

### SUMMARY

The Central London office market is currently experiencing high completion rates but very low levels of new starts. Given the historic close relationship between completion levels and rental movements, we believe the development downturn will lay the foundation for medium term rental recovery.

### OVERVIEW

By its very nature office development is a high risk activity. High existing use values, high costs of construction and the strong cyclical nature of its occupier market means development is not for the faint-hearted.

With the advent of the credit crunch and its economic aftermath, development activity has been constrained by a very hostile backdrop. Firstly, there is greater risk awareness across the sector. Secondly, most banks and other debt providers have pulled back from lending to the commercial property sector, access to finance is more limited than previously and the cost has increased. Thirdly, yields have increased sharply over the last 18 months lowering the projected end-values of development, while rents are also falling and voids are increasing. Finally, construction costs that rose sharply up until 2007 have only just started to fall and remain high.

In the City office market for instance, prime rents have fallen by a third from their peak in 2007 and rent-free periods have more than doubled, while investment yields have moved out by 250 basis points and transaction levels are down significantly. On the other hand, construction costs have only fallen by circa 15%. There were similar changes across other Central London markets.

### Key City and West End Office Market Indicators

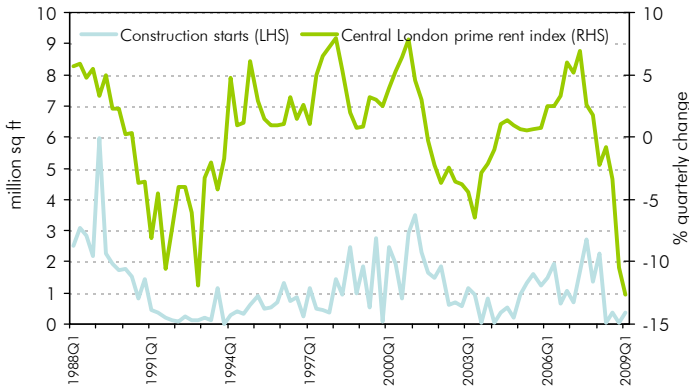
	2007 Q2	2009 Q2
<b>Prime Rent (£ psf)</b>		
City	60.00	43.00
West End	120.00	80.00
<b>Rent-free (months)*</b>		
City	12-15	33
West End	12	18-24
<b>Yield (%)</b>		
City	4.25	6.75
West End	3.50	5.50
<b>Construction costs (£ psf)</b>	260-280	220-240

Source: CB Richard Ellis. \* On a 10-year lease.

These changes have had a major impact on Central London development, and only a small amount of development has started over the last year. In the 12 months to Q2 2009, there were only 1.0m sq ft of construction starts; by comparison in the 12 months to Q2 2008, there were 6.6m sq ft.

Historically, there is a very strong relationship between rental growth and development in Central London. Once rents start falling, construction activity slows and in a period of consistently falling rents, development completions stay significantly below the long-term average, and vice versa.

## Central London Prime Rent Index and Construction Starts



Source: CB Richard Ellis

Evidence from the last significant downturn in the 1990s points to a long lag between recovery in the occupational market and recommencement of significant construction activity. For example, construction starts in Central London remained below 2m sq ft per annum for four years (1991-94) and only rose above this level when rents had been rising for two years.

### CONSTRUCTION COSTS

Construction costs have risen at a higher rate than general prices over the last 10 years.

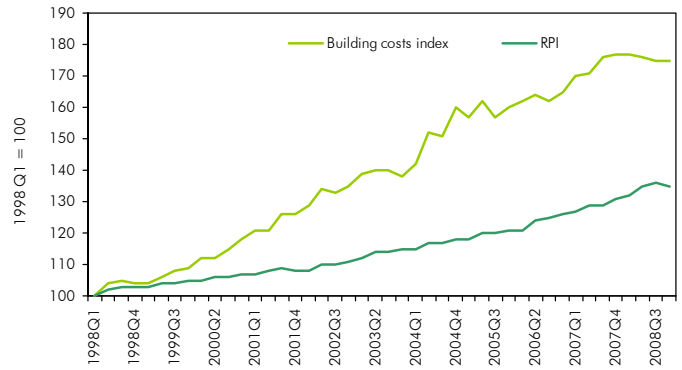
High oil prices have been a significant factor in pushing input costs higher. The price of oil nearly doubled in 2008, peaking at \$147 per barrel in July 2008. Since then, it has fallen to \$35 before rebounding to \$70 currently.

In addition to surging oil prices in the first half of 2008, steel prices rose sharply – increasing by 50-75%. In contrast, concrete rose by only 14%. In real terms, the prices of both steel and concrete have risen faster than the rate of inflation. As economic conditions deteriorated, steel prices have been forced down – falling by about 40-50% over the last 12 months.

However, recent reductions in input prices have been partially offset by the depreciation of sterling, which in the 12 months to the end of 2008 lost 30% against the euro and 36% against the dollar.

The rising cost of labour has also added to the cost pressures faced by developers. Between January 2000 and April 2009, UK construction earnings rose by 38%; however, recent data show that earnings have fallen slightly since September 2008. Earnings in London are likely to be higher reflecting the higher costs of living in the capital; for example, average weekly earnings in the construction industry are 30% higher in London than the UK average.

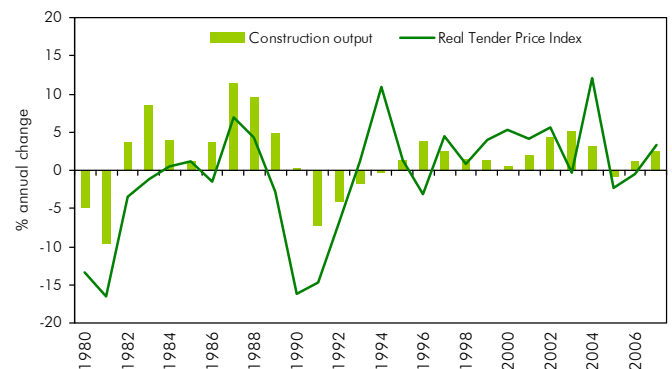
### Building Costs and RPI



Source: BCIS and EcoWin

However, with the continued contraction of UK economic activity, construction costs will come under considerable downward pressure as construction activity remains weak. Output in the construction sector is extremely volatile and tends to respond swiftly to changes in economic output. The recession of the 1980s triggered a sharp fall in construction output as did the 1990s downturn. Historically, there has been a very strong relationship between the growth in construction output and the real change in tender prices, which is mirrored by construction costs. For instance, in the 1990s when the economy contracted by 2.5% peak to trough, construction costs fell for 12 quarters.

### Construction Output and Costs



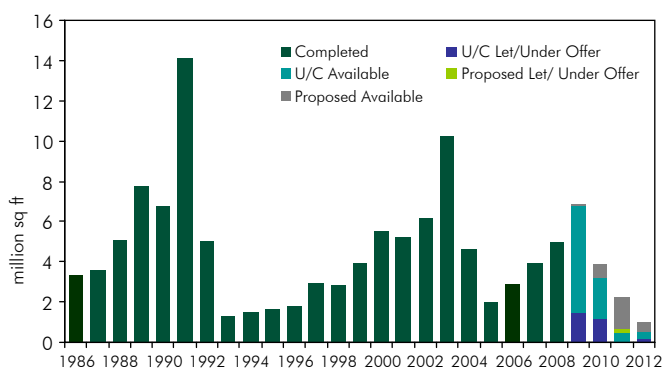
Source: BCIS and EcoWin

Therefore as the weakness in the economy feeds through to reduced construction activity – a trend already well-established in residential and commercial markets – construction costs will fall. In these circumstances, tender prices should fall significantly in 2009 and 2010. Indeed, this is anticipated by the construction industry with Davis Langdon predicting that construction costs in Greater London will fall by 5-7% in 2009 and by 6-9% in the following year. These forecasts for London are broadly in line with those for the UK.

### CENTRAL LONDON DEVELOPMENT

Strong office demand and increasingly tight supply conditions across Central London in 2006 and 2007 brought about a sharp rise in development activity, particularly in the City. As a result, some 5.0m sq ft of schemes were completed across Central London in 2008. This is expected to rise to 6.8m sq ft in 2009 as some schemes delayed from 2008 complete. Thereafter, development completions will fall quite sharply as planned developments have been quickly postponed or cancelled due to the weaker occupational market and lack of finance since 2007. Although, when a developer chooses to postpone a consented development, it is possible to extend or renew lapsed consents rather than implement in a weak market.

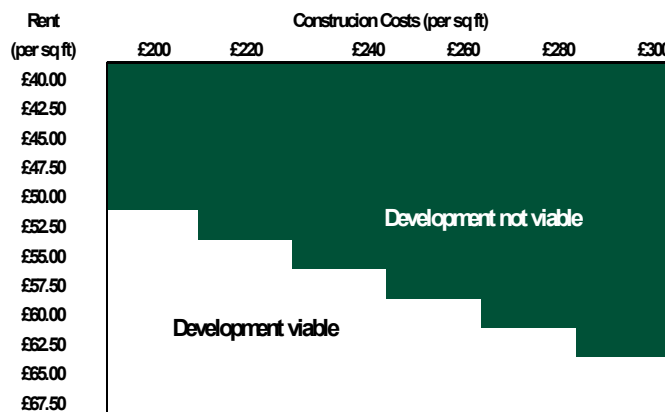
### Central London Development Pipeline



Source: CB Richard Ellis

One of the reasons for the significant curtailment of development activity can be illustrated through a financial analysis of a hypothetical City development. The sensitivity of a hypothetical City scheme's viability to rent and construction costs is demonstrated in the following table. Our financial analysis assumes a 20% developer profit, a fixed land value of £120 per sq ft, a finance cost of 7%, an exit yield of 6%, a void of 12 months, a rent free period of 24 months and standard assumptions regarding professional fees. Holding all assumptions fixed with the exception of rents and construction costs, it is possible to assess the effect of changes to these key metrics on a scheme's viability (i.e. profitability of less than 20%).

### Office Development Viability – Hypothetical City Development



Source: CB Richard Ellis

Current market conditions in the City dictate that development is not viable. At a construction cost of £240 per sq ft (construction costs are approximately £220-240 per sq ft for a building in the City), only schemes that anticipate achieving a rent of £55.00 per sq ft or above would be viable. However, if construction costs continue to fall to say £200 per sq ft, a rent of just over £50 per sq ft is needed. This compares with mid-2009 prime City rents of around £43 per sq ft. It is a similar story in the West End, albeit developments become viable at a higher rental level.

Looking ahead, the first schemes to become viable will comprise developments with a significant pre-let element. While pre-lets generally secure a rental discount to the prevailing market rate in a strong market, the opposite applies in a weak market with a premium over the market rent required to make the first schemes viable. In such a scenario, a balance will need to be struck between the interests of the developer and occupier. This will require the developer to accept a lower profit for reduced risk for a pre-let and removal of an allowance for a void period will reduce costs to assist viability.

## DEVELOPMENT ISSUES IN THE DOWNTURN

Developers face difficult decisions as they try to time the completion of their scheme(s) to maximise profit. A number of important issues emerge from current market conditions.

The availability of finance will be a major factor determining the level of future development. At present, foreign finance has been crucial in enabling several key schemes to start construction. For example, the Shard secured funding from a consortium of Middle Eastern backers and Pramerica – the US division of Prudential. Going forward, developers will need to tap into wider sources of funding to offset the reduced availability from traditional sources. We might also see a change in funding models as lenders look to equity share as a way of increasing profit margins.

A feature of the recent development cycle has been that schemes have become increasingly extravagant and therefore costly to build, especially tower schemes. Now we will see a trend towards cost engineering to align building costs with the realities of today's more conservative market. As a counter however, developers will also face the additional costs of complying with the Better Building regulations and energy efficiency standards.

As a result, it will be some time before we see any commitment to start a large-scale development unless there is a substantial pre-let element. It does mean, however, that those few schemes which have recently started on a speculative basis will face little competition and therefore will be in a strong position to take advantage of a rising market.

As the UK comes out of recession and conditions in the Central London market improve, owners will look more carefully at refurbishment opportunities in order to avoid delays or costs associated with planning applications for new developments. For a major refurbishment, this could involve a cost saving of around 25% over a new build, if the cost of making the building compliant with new sustainability requirements is not excessive.

## CROSSRAIL

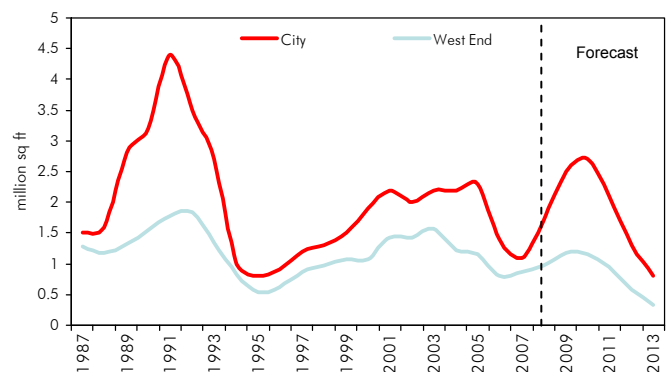
Even with favourable changes to the occupational markets that improve development viability, developers are faced with new challenges, such as the introduction of Section 106 contributions for Crossrail of £19.80 per sq ft. The Crossrail levy will apply from 2010 to new development that adds to the existing office stock within a 10-mile area of Central London called the Central Activity Zone. Although, some schemes that recently received planning permission have been required to make a Crossrail levy at a reduced level.

The charge, which is in addition to other Section 106 contributions that developers might face, will threaten the viability of some schemes, particularly the more marginal schemes in non-core areas. To counter these concerns, the Mayor, Boris Johnson, is considering introducing a test to assess how much a developer could afford to pay towards Crossrail without threatening a scheme's viability.

## IMPLICATIONS

With new construction activity remaining subdued in the short term, this year's peak in development completions will be followed by a sharp decline in the amount of new supply coming into the market by 2011-12. Measured on a three-year rolling average basis, projected new office completions in both the City and West End fall to levels around or below those seen in the aftermath of the 1990s market downturn.

### City and West End Development Completions, 3-year Rolling Average



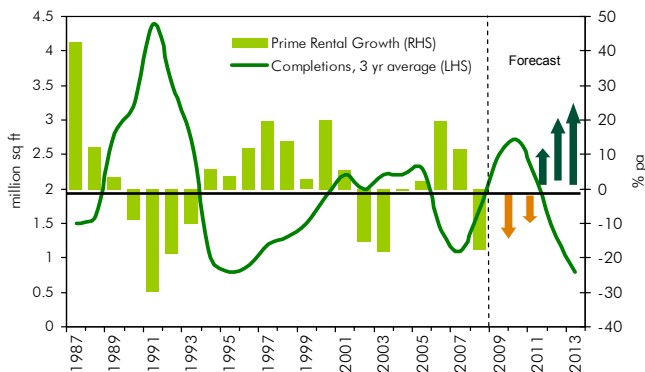
Source: CB Richard Ellis

These trends will be in line with the traditional highly cyclical pattern of office development in the City and West End, in which periods of strong rental growth have stimulated high levels of development activity followed by rental downswings in which development activity falls. A period of subdued development is typically the precursor to renewed rental growth due to supply shortages.

Past experience of City market cycles shows that when the three-year average of development completions has exceeded 2 million sq ft, prime rents have recorded significant declines. Conversely, periods when the three-year average completion rate has dropped below 2 million sq ft per annum have been marked by rental growth. Of course, rents are also driven by variations in the strength of occupational demand, but the evidence of the very close relationship between development completions and rental growth suggest that the City market has been unable to absorb new supply exceeding 2 million sq ft per annum over a rolling three year period without rents falling.

In the West End the development cycle is less pronounced than in the City and as a consequence the relationship between rental growth and completion levels is not as strong.

### City Development Completions and Prime Rental Growth



Source: CB Richard Ellis

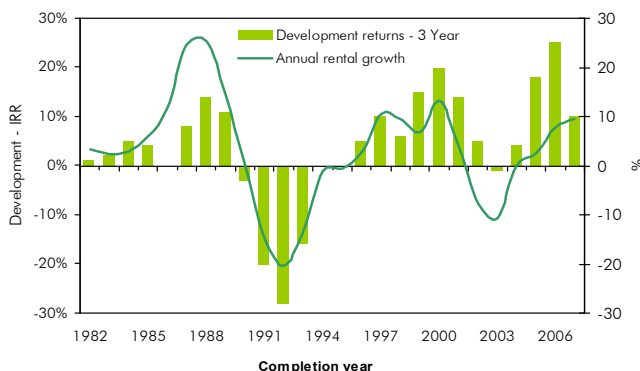
Looking ahead, the projected three-year completion rate in the City will drop well below 2 million sq ft per annum in 2012-13. In the West End, the long-term average completion rate is 1.1m sq ft. By comparison, the completion rate is projected to be only 130,000 sq ft during 2011, almost a tenth of its normal level. Assuming sufficient demand, the City and West End markets will, on past form, see office rents rising again by the time London hosts the Olympics. Rising rents will signal an increase in construction starts, although the next development boom is still some way off.

It is not all plain sailing however, the market is still very weak with rents continuing to fall and concerns remain about the strength of the economic recovery.

Against this background, it would still be brave to start a new development. However, those who do start over the next year are best-positioned to take advantage of the recovery and the next rental peak.

Analysis of the IPD's Office three-year development IRRs [1] supports this. It reveals that developments with strong performances have been timed to coincide with the peak years of the cycle, when development returns benefit from the joint tailwinds of rising rents and declining yields. The reverse is clearly true when the market is in decline, when IRRs are very low or negative highlighting the importance of market timing.

### Office Development Internal Rate of Return and Rental Growth – Great Britain



Source: CB Richard Ellis and IPD. Note: Provisional results only.

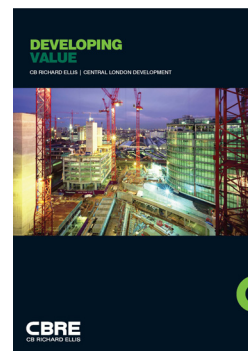
#### For more information regarding the ViewPoint, please contact:

**Kevin McCauley**  
 Director  
 UK Research  
 CB Richard Ellis  
 St Martin's Court  
 10 Paternoster Row  
 London EC4M 7HP  
 t: +44 20 7182 3620  
 e: kevin.mccauley@cbre.com

**Adrian Bunnis**  
 Executive Director  
 Central London Development  
 CB Richard Ellis  
 St Martin's Court  
 10 Paternoster Row  
 London EC4M 7HP  
 t: +44 20 7182 3745  
 e: adrian.bunnis@cbre.com

**Peter Burns**  
 Senior Director  
 Central London Development  
 CB Richard Ellis  
 Kingsley House  
 1a Wimpole Street  
 London W1G 0RE  
 t: +44 207 182 2716  
 e: peter.burns@cbre.com

#### For more information on our Development Team, please click here:



#### Disclaimer 2009 CB Richard Ellis

Information herein has been obtained from sources believed to be reliable. While we do not doubt its accuracy, we have not verified it and make no guarantee, warranty or representation about it. It is your responsibility to independently confirm its accuracy and completeness. Any projections, opinions, assumptions or estimates used are for example only and do not represent the current or future performance of the market. This information is designed exclusively for use by CB Richard Ellis clients, and cannot be reproduced without prior written permission of CB Richard Ellis.

© Copyright 2009 CB Richard Ellis