TRANSCRIPT

Podcast : A deep dive into the UK office investment market

Scott Tyler: [00:00:00] Hello, and welcome to the latest edition of the Allsop podcast, PropChat. I'm Scott Tyler, and I'm delighted to be joined today by Henry Kilmister, partner in the National Investment team, and also Matt Millman, partner in the City Office Investment team.

Henry, can you tell us a bit about yourself?

Henry Kilmister: Hi, Scott. Um, yeah, so I'm a partner in the national office investment team, predominantly focused on the Southeast office and regional office markets.

Matt Millman: Hi, my name is Matt Millman. I've been a partner at Allsop for over 11 years, I am a city investment agent, which is anything sort of east of Kingsway, going up to Camden, down to Southwark. Um, but generally all, all things city.

Scott Tyler: So we're going to be talking about everything in the office investment market from the good, the bad, and the ugly. We'll be covering pricing, yields, rents, the nuances in the market, predictions, trends, where to invest and why, who's buying, who's selling.

Shall we kick off [00:01:00] with an easy question to start with? Has the UK office investment market genuinely bottomed out, or are we still in price discovery mode? Henry, do you want to kick off?

Henry Kilmister Yeah, sure. Um,, It's not as easy just to say we are at this point or we're not.

I think there's nuances to it. I think ultimately, it depends on the quality of the stock and also location, and that desirable factor ultimately. I think there's never been a bigger disparity between prime and secondary, and I think definitely secondary, there could be arguments that there's, there's more pricing to come off.

I think when you look at where debt costs now stand and where the swap rates say it's close to, what is it, like 4.5, 4.6% at the moment. I think that when you're looking at some of these buildings and knowing that in order to get them let, the amount of CapEx that needs spending and the risk around that CapEx, I still think on some of them, there's pricing movement.

However, [00:02:00] if you're looking at absolute prime, I think ultimately, it does feel like we've bottomed out, and I feel like the fact that you've got institutional money starting to come back and look at it, I think that's a pretty strong telling factor. Um, so we've seen, just to give an example, we've seen the likes of, Aberdeen, buying for their Borders to Coast fund, One George Street in Bristol, which, um, again, gives a lot more confidence to the

market, single let, 10-year income. And they paid, I think it was about 7.25% for that. So yeah.

Scott Tyler: Matt, same question to you in the London end.

Matt Millman: Yeah, I think it's, I agree with Henry. It's slightly nuanced. I think if you look at investment volumes, uh, with sort of £3.85 billion in the West End likely to fall well short of £5 billion, achieved last year, but still well ahead of '23 and '24.

The city is similar. I think we'll probably end up similar to sort of £4.5 billion, which we had last year, which again is a big improvement on '23 and '24. So certainly, in terms of volumes, you could argue [00:03:00] things have improved. I think '23, '24 were, were certainly more challenging years of price discovery.

That-- It was certainly more prevalent then. I think there was a lot of talk of trying to catch a falling knife. A lot of people didn't really know what things were worth at the time. And for certain assets, there was just no market for anything. Whereas I would argue today, even in sort of fringe zone one, zone two offices, you are now seeing competition for assets, which certainly wouldn't have happened two years ago.

So, I would also say there's certainly a lot more buyers around now than '23 and '24, and there's no question that Central London offices as a brand and a sector is, is much more popular from a global perspective. But as Henry says, I think it's really important to distinguish between prime and secondary assets.

Uh, the gap has never been wider. I would argue non-prime offices have now bottomed out potentially. We're starting to see fringe zone one yields at eight and nine percents. They would've [00:04:00] been in the five percents not so long ago. There's a, there's a deal in Borough actually, which traded a couple of months ago at close to a nine percent yield, right on top of the station, good quality, bought by a French CPI fund for around twenty-seven million.

And that wouldI think it traded in the fours last time round. So with, with prime assets, I think it's, it's more challenging 'cause whilst we recognize some of the firms have moved prime yields out towards five and three quarters, I still believe that if a, a prime rack rented freehold next to the Bank of England were to trade, I think it would be around five and a quarter.

But that's also reflected of lot size, sub fifty million, probably five and a quarter. But hundred million plus, I think we're probably talking more five and a half to five and three quarters. So, I think certainly from the city perspective, the days of price of discovery are probably over, as we have enough evidence to have a good idea of where things will land.

Now it's just a case of vendors being willing to sell at market pricing.

Scott Tyler: Okay. So just on that, [00:05:00] uh, do we feel the flight to quality is now sort of a permanent phenomenon, or is it just a sort of cyclical phenomenon?

Henry Kilmister: I think ultimately everything when we're looking at it from an investment standpoint and when we're speaking to clients, it is always driven by what the occupational market is doing.

And I think ultimately, the key takeaways that I think we're seeing from both the Southeast and the national markets is occupiers continue to chase the best in quality stock. In order, that's a matter of also wanting to present to their company in the right manner and also wanting to get staff back into the office, give them a reason to be there.

And I think that ultimately will lead what happens in investment. And I think the key bit is from the investment front, I think if you're looking at pure liquidity and where the most liquid market usually is, it's when you've got the institutions buying. And ultimately, I think they are gonna continue to want to acquire the best in stock because it means less risk on a [00:06:00] CapEx front, and also void costs and vacancies.

So I think from my point of view, that will remain. I think, yeah, if you're looking at the stats from the occupier side, I think from the Southeast, over 80% of takeup is driven by grade A best in class. So, I can't really see that changing that much.

Scott Tyler: Okay. Matt, same for you.

Matt Millman: Yeah. I, I... Is the flight to quality now permanent? It's an interesting question. I think you have to look at previous cycles. I think certainly back in 2008 you were seeing 7% yields on super prime streets such as Gresham Street, but the occupational market was poor and, and, and things are very different now.

Back then you were seeing brand new buildings sitting empty for several years. I mean, as Henry says, investor demand typically follows occupational demand, and there's no doubt that best in class offices located at traditional core markets within, say, five minutes of major transport hubs is where occupational demand is.

Um, investors are very particular about what they buy right now, but that's [00:07:00] the same in any challenging market. What I would say just on the occupational side is it's becoming more and more apparent that not all tenants want to pay £90, £100 a square foot plus in the sort of core city locations in the best buildings.

And these options are becoming more and more scarce. So what I can see happening and, and already is starting to happen is the sort of A minus, B plus buildings where rents are sort of 60s and 70s pounds per square foot are suddenly more appealing. And as I say, as the good quality space is absorbed, this secondary stock will also come to the fore

for occupiers, and I expect these buildings will also increase their appeal to investors, and that chasm between prime and secondary will start to decrease.

What I would say is some locations such as Zone 2 London offices and outwards will continue to struggle. I just think a lot of these buildings are now being changed to, you know, hotel, residential alternative uses, and [00:08:00] thankfully, local councils are being a bit more progressive in terms of that trend.

Henry Kilmister: I think that point you said about buildings where the rents aren't quite at that rack rented point yet, and investors looking for best in quality stock on that front.

I think that's quite interesting 'cause we are seeing more investors also looking regionally and in the southeast where buildings say that they were comprehensively refurbished and let in like 2021, 2022. Because they almost know that the building quality and fabric is still very good, and they're not having to do that much to realize the rental growth that we've seen in the subsequent years since COVID.

I think that's an interesting factor as well within the market that we're seeing.

Scott Tyler: So it also begs the question on this is w- what matters more today, location or building quality? And I guess you could probably introduce, you know, town, city core against business parks, Henry, on your market.

Henry Kilmister: I think location has probably never been more important and prevalent.

Sort of as Matt touched on in the city, I think when you're looking at [00:09:00] the sort of southeast, you've got probably the main centres are the likes of Reading, Maidenhead, and people ideally, and occupiers want to be right next to the train station or where there's a load of amenity. I think then especially when you're still looking at the regions where you're looking at where the highest rents are being achieved- in the likes of Manchester, Leeds, Bristol, it is very much that central focus where you've got a lot of amenity option. But I think a lot of that is also then being driven by the lack of space and pipeline that is actually around. The development pipeline, we haven't seen that much being developed.

So to a point, you're being driven by what you can actually get. Those buildings that are then have the location factor become even stronger in this market, in my view.

Scott Tyler: Matt, would that be the same in London and the City a year?

Matt Millman: Yeah, absolutely, I think it's, it's location, location, location very much in, in the city. It really is. Uh, there's a lot of investors who won't look [00:10:00] at anything that's more than five minutes walk from a, a major transport hub, particularly the Crossrail stations. And you know, we've talked about the polarization between prime and secondary.

It's really stark, even if a building is one or two streets off prime. I mean, we saw a deal, the Worship Street estate in EC2, just north of Finsbury Square. I, I would argue Finsbury Square is super prime location nowadays between Liverpool, Moorgate, Crossrail station, and obviously on a square. Worship Street is just one street off that, and we saw the, the, the deal trade at 75 million, just £385 a foot.

And historically speaking, that price per square foot is, very low.

Henry Kilmister: I think also when we're talking about sort of location is in town centre

out of town, I think it also is driven by the investor type and what their sort of return requirements are and criteria are.

So for example, obviously we, acted for one of our private bank mandates, earlier in the year, and we [00:11:00] bought a single let office building in Stockley Park, which you'd argue is out of town, but the building had been comprehensively refurbished, um, single let to Reckitt, so a blue-chip covenant. No risk whatsoever on that front, from a CapEx front or from an income front.

And it also offered great value compared to the historic levels of the market. So we ended up acquiring that for a yield that reflected 9% for 10-year straight income, which would've a long time ago, that's a bit unheard of, which it-- that looked very favourable for those sorts of investors that are looking at purely on a cash-on-cash basis.

Scott Tyler: Yeah. I just want to touch a bit more on rents and how much further can rents really grow in the best office locations. I mean, Henry, we, we've just seen Reading hit 60 pounds a foot.

Have you, have you got a thought on where rents are sort of going?

Henry Kilmister: I think it's, it's so hard, isn't it, always to say like, "Oh God, the, the rents look so big already.

How are they gonna keep growing?" But I think what it generally boils down to is, again, supply and demand dynamics, and the fact is we have [00:12:00] not been developing enough over the last five years. And I think that's why you've had the likes of, so for example, obviously we're saying the Southeast there, Reading has grown massively.

You talk about it, it didn't seem that long ago we were talking about 38, 30s, and now we're hitting 60 because of, um, Station Hill being developed in the city centre. And then you look at the regions and like, for example, Leeds, it wasn't that long ago we were saying £36 square foot. It's now over 50.

And I think it is purely a factor of we have not seen the stock being developed. And whilst, there has been negativity in the media regarding occupiers and them being in the office, I do think it does feel like in the last 12 to 18 months that has shifted even more so, and there are more companies wanting to be back in the office and realizing the productivity levels that you gain from being all working together, and also the younger generation of how they learn and develop their own skills.

Scott Tyler: Yeah. And Matt, I mean, we've seen some huge growth in the city and the West End over the last 12 to 18 [00:13:00] months. You see it continuing?

Matt Millman: Yeah. I mean, look, I think most people are predicting rents to grow hugely in the next certainly three to four years. Uh, we've talked about the constrained supply pipeline and, and that will only lead one way.

You know, there's just no space available. I think the demand for large floor plates around areas like Liverpool Street is just unprecedented. We're starting to see in the last six months, rents touch £150 a foot plus for low-rise buildings in the city. We'd seen that for towers previously, but now it's, you know, there's, there's a few deals I know Sullivan & Cromwell are rumoured to be under offer at 75 London Wall at a best rent of £160 a foot, £154 blended, which is, which is unbelievable really.

Uh, we're also seeing similar on Cannon Street, or the address is actually 10 King William Street, that is now under offer as a whole to Jones Day Solicitors [00:14:00] at, uh, you know, at, at over £100 a foot. So- It, it feels like £150 a foot is gonna become the norm for the best space in the city. And given the lack of supply, you can only see it going well one way, and it's gonna get to the point where the best suites and the best location, owners will just be able to almost name their price.

Um, and it's whoever, whoever wants to take it the most. And as I said earlier, I can see that demand having to filter out to other parts of the city, just to accommodate it. And, you know, to build a new office building today, it costs around £600 a foot, just hard costs. So, these rents need to be achieved just to, make it viable.

Scott Tyler: So obviously growing rents, but obviously, you know, historically quite attractive yields available. Um, so the question, are current office yields generally attractive or are investors underestimating that occupational risk and obviously cost of running buildings?

Henry Kilmister: There's varying factors in regards to what kind of style of building you're buying and if it [00:15:00] is exposed to CapEx risk.

I think if you're looking at, sort of, buildings that were let up in 2022-ish time, they've had the money spent on them, they're not so exposed to risk. I think the yields genuinely look attractive because there is still significant rental growth to be realized.

So if we're looking at, say, prime regional rent of say six-- I mean yield, sorry, of 6.5, 6.75%, you're then saying some of these buildings that are being paid that you could see your rents jump, say, another £15, £10 per square foot, which I would say that looks very attractive when you're looking at other sectors across the market where are, are we seeing rental growth slow down in other sectors?

The point is you're getting a lot more discount on where the yields used to be. And for me, I think that's the attractive point of it.

Matt Millman: Yeah, I think there's no question, historically speaking, yields are at an all-time high. When you start to see seven percent plus in core city locations, then it, it generally does suggest that, that the market is, is bottoming out if you're, if you're looking at [00:16:00] previous cycles.

We're saying the prime yield is probably around five and a half percent. I know a few other market commentators have, have moved their yields out twenty-five bips in the last quarter or so. I would say that's purely a function of, increased interest rates and gilt, gilt rates as well, have both increased by about a hundred basis points in the last twelve months, and that inevitably has to impact yields.

In terms of evidence on the ground, there's very little prime evidence around, I would suggest, and even the deals which are trading in the five percent yields at the moment, we've talked about rental growth, that's, that must be rental growth implicit. Um, so what is the true prime yields? Time will tell.

Scott Tyler: One thing I've heard is occupiers are buying their own buildings. I mean, is this true? And if true, why is that happening?

Henry Kilmister: Yes, we're definitely seeing that. I think the main reasoning is because of where pricing sits compared to historic levels.

Say for example, you had the Bank of New York buy their office building in Manchester that they had just leased on a 15-year lease. I think if you'd sold that [00:17:00] in historic years, that yield that then was achieved would've been a lot sharper. So therefore, it looks attractive for them almost to buy themselves out of the lease and not have to pay that rent for a further 15 years.

And it's an investment at the same time 'cause the cap value per square foot arguably is lower than where it would've been in the past. And then you have the likes of Nat bought their own building in Farringdon that hadeight years remaining on the lease, and they acquired that for just under 40 million, which is £144 per square foot and 11.5%.

Like, I think if you're looking at it from that point of view, an investor would say that looks attractive, let alone for an occupier to be able to release them from a liability on their running costs.

Matt Millman: I broadly agree with you. I think the-- obviously rents are very high at the moment, so if you're renting space, it's challenging.

But also it's a low point in the cycle, as, as Henry says. but in terms of Central London, I think the point is also the scarcity for best-in-class space over the next few years. I mean, we saw it with State Street or New Bridge Street. [00:18:00] Uh, if, if you want a over three hundred thousand square foot HQ building, there just aren't many options.

So if you can buy one, and Helical sold it for, I think it was about seventeen hundred pounds a foot, then it's a case of being able to buy one rather than paying huge amounts o-of rent in the next few years

Scott Tyler: So, I mean, offices have been playing sort of second fiddle to obviously the industrial market and the retail warehouse market over the last couple of years.

Who do we think will be the major buyers of UK offices, let's say over the next sort of five years?

Henry Kilmister: I think if we're arguing that the market is starting to bottom out, I think you will have the likes of PE money and AMs and DMs returning to the market. Um, and I think we have started to see that more and more, because of the, I guess, the core plus value add returns that are there.

And then I think the other interesting part will be how these pooled council money sort of funds, where they're going to invest. Ultimately the Southeast and the [00:19:00] regional office markets will not be their initial preference, but they've got that much money to invest that their weighting has to remain across the fund that I think we will see that then over time come out.

Obviously, I think they'll probably start in the likes of in central London and, um, but then afterwards you'll see it progress further out and look to other sectors. There is gonna be that much money to invest that, that it's gotta come from there at some point, in my view. But-

Scott Tyler: And you get the lot size as well because these funds are

Henry Kilmister: yeah, they, they've got to put the lot sizes down at, at the end of the day. Yeah. So if we like look at it broadly, we've got Borders to Coast, you've got the Welsh Pension Fund, you've got LPPI, and they're being managed by the likes of Aberdeen, Schroders, Knight Frank IM.

Yeah. I think at some point they've got to start looking at the regional market, and I think they already have started. So like LPPI, they just bought, um, The Globe in Manchester, which was basically 10-year income, and they bought that at 7%. And then as I said, you've had Borders to Coast already buying.

WPP, they haven't done offices yet, so to speak. [00:20:00] Um, but they are start, it's starting to build that, um, momentum of investing.

Matt Millman: Yeah. It's, it's, it's the same in the City. I think I mentioned earlier there's more buyers now certainly than probably the last three years, and we're starting to see UK institutional capital look at deals again in the City.

Aviva, DTZI, Aberdeen, they've all got active requirements at the moment for City. Uh, being very selective in terms of what they're looking for, but that's the same as everyone. You know, London's global appeal, when I mentioned offices as a brand is, is improved substantially on a global perspective in the last 12 months.

We, we always have the safe haven status as well. I think in times of economic uncertainty, and that's certainly on a global scale at the moment, we're seeing certainly a lot of private European investors, private Spanish, French, German, even Turkish investors, very active in the city core. But it really is focused around Bank of England, Liverpool Street, good quality assets.

[00:21:00] And, uh, yeah, I, I suspect that will be the same over the next couple of years.

Scott Tyler: Okay. That sort of leads me on to, you know, if you had £100 million to deploy today, and I'm sure Matt will say London and Henry will say the regions, where would you look in London, Matt, to put that 100 million today?

Matt Millman: In one lot size?

Scott Tyler: Yeah.

Matt Millman: Yeah,I, absolutely I would, I would say Central London. I think it's, it's interesting times at the moment. I know there's obviously significant challenges in relation to build costs and debt costs and, and that is really challenging. But the reality is yields are higher than they've ever been probably, and it's not like 2008 when the rental market, the occupational market was on its knees.

You can actually let your buildings at higher rents than ever before. So if you are a cash buyer and you can afford to wait for interest rates to come down sort of in 12, 18 months' time, potentially sooner, then I think it, it will be seen as one of the best times to buy in a generation.

Scott Tyler: And Henry, [00:22:00] probably in 50 million chunks rather than 100 million chunks for the regions.

Where, where would you like?

Henry Kilmister: Yeah, I, I think to be honest with you, if you're looking at that 100 million, I think maybe it's 'cause Matt's been, uh, telling a very compelling story, but I probably would be looking at Central London because if you're looking at where yields are historically, and I do think that, uh, I would look at it and go, "That looks very attractive," and there's gotta be op- opportunity there.

I think if we're looking at the regions then

To be honest, it-- all the regional markets are performing very well. I've always been a fan of Leeds 'cause I think it's always been a little bit behind the likes of Manchester and Birmingham and Bristol, and I think there is a lot of opportunity there.

So I'd go Leeds.

Scott Tyler: So just to sort of conclude, we've taken on a lot on board there. I thought it might be fun to finish with a sort of bonus quick-fire questions with just one or two word answers from the pair of you. First question: Best UK office investment market today, Matt?

Matt Millman: [00:23:00] City of London, next to Bank or Liverpool Street.

Scott Tyler: Henry.

Henry Kilmister:: Uh, if I'm saying regional, I'll say Manchester.

Scott Tyler: Most underrated office market.

Matt Millman: I'm gonna say South Shoreditch. I think Shoreditch has amazing amenity, and certainly the southern bit can offer real large floor plates potentially. There's a few big sites there, and you're also within walking distance of Liverpool Street.

Henry Kilmister: I think it's hard to say any market's underrated 'cause I think there's always individuals that like certain markets more than others, and there's been specialists in those market. But if I'm looking at the historical point and where people usually have invested, I, again, I would probably stick with Leeds.

I, I really like it as a market and I think the rental growth story that we've seen in the last five years really pushes it home.

Scott Tyler: One for you, Matt. Prime London, buy, hold, or sell?

Matt Millman: Definitely buy.

Scott Tyler: Thought you might say that.

Henry, Manchester or Birmingham?

Henry Kilmister: I'm gonna go with Manchester

Scott Tyler: [00:24:00] Okay. Biggest risk to values, Matt.

Matt Millman: I think generally the market is pricing in probably another two interest rate rises.

I think if we see significantly more than that, I think that's probably the biggest risk. You could talk about the occupational market potentially weakening if the economy weakens, but again, I think that's probably less likely based on what I've mentioned earlier.

Henry Kilmister: I'm aligned with Matt on that front, it's the debt position and the external factors that sometimes the market can't control. So like the likes of we've had obviously the Middle East conflict that we-- I think we all came into this year with a lot more impotence, sort of the market was improving and then that did have a bit of an impact and, um, so it's those sort of external factors that are almost uncontrollable sometimes.

Scott Tyler: Biggest opportunity. Gonna go with you, Henry, first on that.

Henry Kilmister: I think it'll be interesting seeing these masters trusts that are gonna be entering the market in the new year, and basically you've got the likes of the Nest Trust that CBRE IM have just won the [00:25:00] mandate on. That trust totals 68 billion, and they're gonna have to spend a billion next year.

So I think it's that excitement on the point of we're gonna see aggressive buying hopefully, 'cause they, they have to buy and they have to get the money invested. So it's that return of liquidity to market hopefully. But to me, that's the exciting point for probably everyone across all sectors.

Scott Tyler: Sure. Matt?

Matt Millman: South Shoreditch, again. As I say, I think things are gonna filter out from, Liverpool Street, and that's the only place you can house bigger buildings, potentially.

Scott Tyler: One prediction for 2027.

Matt Millman: I think rents of £150 a foot will become the norm for low-rise city offices. We're already starting to see it.

Henry Kilmister: And yeah, I think along that point, I think we're gonna see more sort of markets, especially across the southeast. I think you are gonna start seeing more hitting that high 40s, 50s, and it'll become more of a norm rather than us going like, "Wow, h- how is it these levels?"

And you're talking some of these sort of southeast and Greater London markets, they're talking about hitting £75 square foot, which when you obviously compare it to the likes of [00:26:00] Central London, it, um, sometimes looks a bit wow.

Scott Tyler: And the last one, one prediction you will probably be mocked for today, but you will be proved correct.

Matt?

Matt Millman: It is what I said earlier. I, I really believe people will look back in five years' time and, and see this as probably one of the best buying opportunities.

Henry Kilmister: I'm actually aligned. I agree. I think it's ultimately, I think there's a lot of money that's looking at a lot of other sectors at the moment, and I do think they may miss a trick by not focusing harder on the office sector.

Scott Tyler: So my one or two word answers were elongated a little bit. But we have got a pair of investment agents here. So guys, I think that is a wrap. Thank you for your thoughts and insights. Uh, your time is appreciated. From me, Scott Tyler, Henry and Matt, thank you for listening. Thanks all.

Matt Millman: Thanks very much.