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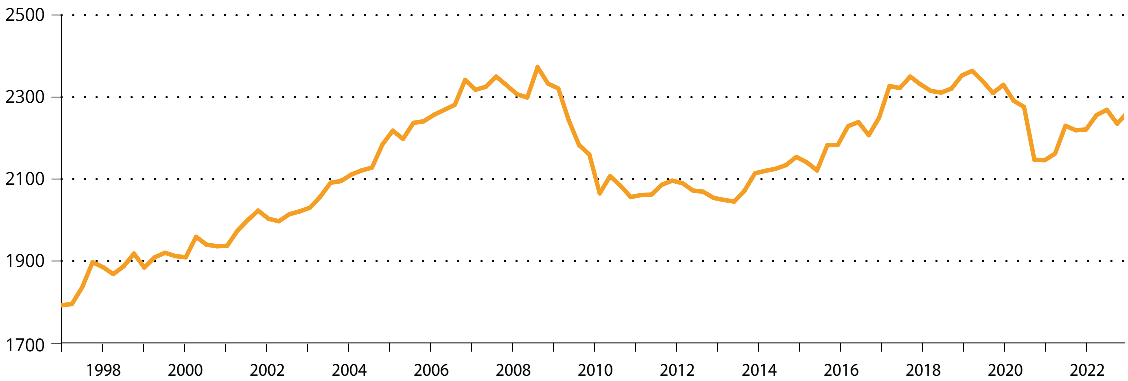
Q2 2023 MARKET UPDATE

The London commercial property market has faced significant challenges, but the market is beginning to show signs of stabilisation. In our Q2 2023 update, we look at the biggest factors influencing the London market right now – and explain why new EPC regulations represent a key business opportunity.

In April 2023, the International Monetary Fund (IMF) said it expects the UK to be the worst performing G20 economy in 2023, and it foresees a "rocky road" ahead for the global banking markets.

Whether these gloomy predictions for the broader macroeconomic climate will come to pass remains to be seen. In the construction industry, there's no doubt that there has been plenty of volatility in the market. We have spent the past year grappling with a veritable smorgasbord of disruptions, distractions and challenges: rising commodity prices, a weakened pound, the Russo-Ukrainian war, supply chain problems, and high energy prices.

UK Workforce Jobs SA:F Construction (thousands)
Source: ONS



LABOUR COSTS REMAIN A KEY CONCERN, AS OTHER COSTS LEVEL OFF

Inflation has been the most disruptive force. Material prices in the UK construction industry increased by 10.4% in the 12-month period to January 2023. Whilst the rate of annual price growth has slowed from the record increase seen in May 2022, prices remain above historic price levels.

Energy and labour prices have been the two biggest factors influencing cost hikes. The price of energy-intensive materials rose by more than 50% in the last 12 months, while there was a 12-14% increase in labour costs in 2022.

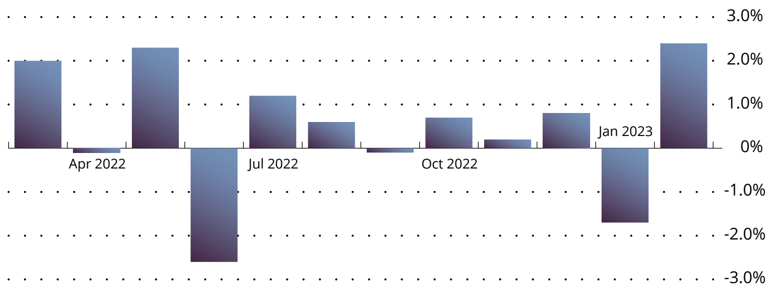
When it comes to skills and labour, this is a structural issue – one that has been years in the making. The fallout of Brexit, COVID-19, and an ageing workforce means 225,000 additional workers will be needed to meet UK construction demand by 2027, according to the Construction Industry Training Board. In Greater London alone, an additional 22,800 will be needed.

What we are starting to see now, however, is signs that inflation is slowing down. Wholesale energy prices are falling. Some materials appear to have reached a price peak with the prices beginning to drop for some materials such as steel, drywall and timber, meaning the rate of inflation will slow as we predicted in Q1. At a national level, the Office for National Statistics (ONS) reported a drop into single-digit inflation (8.7% down from 10.6% in February) for March 2023.

LONDON OFFICE LETS ARE EXPOSED TO WINDS OF CHANGE IN BANKING MARKETS

Monthly construction output is estimated by the ONS to have increased 2.4% in volume terms in February 2023; this follows a 1.7% fall in January 2023, with February 2023 being the highest monthly value in level terms (£15.5 million) since records began in January 2010.

Construction output
Source: ONS



Long term construction output
Source: ONS

Yet growth was driven primarily by repairs and maintenance, not new work. Alongside the monthly increase, the ONS reports that construction output saw an increase of 0.9% in the three months to February 2023. The increase came solely from a rise in repair and maintenance (3.1%), as new work saw a decrease (0.5% fall).

Reflecting this wider UK trend, we are witnessing a slow down on new major projects in the capital, particularly in the residential space. Even office schemes – which are still strong performers, particularly in areas such as the West End – are starting to suffer 'viability creep'.

Our data suggests the price of delivering a typical new central London commercial office has risen to circa £440 per square foot, roughly 15-20% higher than before the Russia/Ukraine war.

High delivery costs are not just about the price of materials and labour: rising interest rates throughout 2022 and 2023 have made projects tough to justify.

Recent defaults by big-name asset managers in the US commercial real estate market, while a very different market to our own – could also cause disquiet. As debt becomes more expensive, there have been calls from banks for more equity to be committed upfront to projects. Rents are rising, but values have been pushed down. Additionally, many finance products now require high ESG standards to be met to access the best interest rates and to attract quality tenants.

Plot 27 Oxford Science Park *© Bogle Architects*


Portland House © *Landsec*

TENANT DEMAND IS A RACE FOR THE BEST SPACES

Projects - whether new builds or refurbishments – must therefore be as well designed and efficient as possible to interest and reassure investors. There is a clear flight to quality, with tenants demanding low carbon, high performance buildings to tempt people back into the office. Fears of offices becoming obsolete during the pandemic proved unfounded – an office-first approach to working, with flexible and home working a key, accepted component of the working week, now seems more likely.

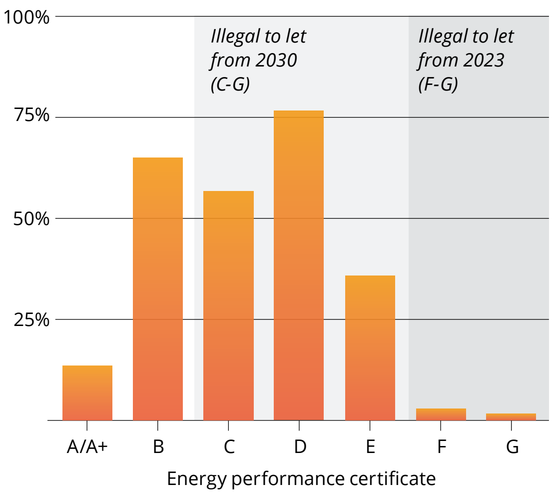
Providers of high-quality, low carbon office spaces with extensive amenities will be the winners in this complex environment. The prices for such properties may be higher, but tenants are willing to pay for quality. In April 2023, London property developer and investor GPE reported a record year for new leases, renewals and pre-let agreements. CEO Toby Courtauld said the current macroeconomic climate "exacerbate[d] the shortage of new deliveries in central London, supporting rents for the best spaces."

ALL CHANGE FOR MEES AND EPC REQUIREMENTS – AND WHY WE SHOULD BE FEELING POSITIVE

It is not just tenants and lenders demanding greener buildings. In the commercial lettings space, we are facing a regulatory cliff edge: from April 2023, both new and existing commercial lettings must achieve an EPC rating of 'E' or above, or else be considered unlawful. Under proposed reforms, 'B' will be the minimum from 2030 – yet the government estimates that, in London, 80-90% of commercial stock is rated 'C' or below.

London office space at risk over new green regulations

Source: Savills



Many major commercial investors, looking to boost their ESG ratings and protect their long-term performance, are seeking buildings that are even more advanced than what will be required under the new legislation. Buildings which fail to meet increasingly stringent standards risk becoming stranded assets.

Compounding the pressure, accurate measurement of the biggest piece of the decarbonisation puzzle – embodied carbon – is still in its infancy, with varying methods used across the industry.

We see the regulations as an opportunity. The growing demand for Grade A commercial stock will support both the refurbishment and new build markets in the short to medium term.

That said, the industry must rise quickly to meet the challenge. This means making the best use of what we have – reusing and reimaging buildings and materials – and thereby promoting the circular economy. This is also about carefully selecting the right lower-carbon processes and technologies, insisting on quantifiable measurement of carbon reductions, and making embodied carbon reduction a foundational principle of any new project.

The Featherstone Building © *Jack Hobhouse*

LOOKING AHEAD, HOW WILL THESE FACTORS IMPACT CONSTRUCTION OUTPUT?

Overall, the CPA is forecasting a 4.7% fall in construction output in 2023, with a return to growth of 0.6% in 2024.

In the immediate term, the S&P Global/CIPS UK Construction Purchasing Manager's Index, which tracks monthly changes in construction activity, rose to 51.1 in April, up from 50.7 in March. Rising volumes of commercial work and civil engineering activity helped offset a further decline in residential activity.

Total order books remain solid and business confidence remains relatively positive as the UK economy has performed better than analysts suggested, amid signs of a recovery in client demand, despite elevated interest rates and rumblings of distress in the global banking markets.

HOW SHOULD WE HANDLE THESE CHALLENGES?

Market uncertainty, rising input prices, and tough ESG demands are undoubtedly threatening scheme viability for many developers. Strong inflationary momentum continued into Q1 2023, and a knock-on impact is being felt in some key packages, such as MEP contracts and in the Tier 1 supply chain. It will take time for newer economic influences to make themselves felt.

We're optimistic, but there is no doubt the past year has tested the industry. By the end of 2022, construction company insolvencies were happening at the fastest rate since the 2008 financial crisis. The number of insolvencies in February was 12.7% higher than in January and 6.5% higher than a year ago. Material inflation, availability of labour and delivering margins on schemes contracted prior to the significant cost increases is proving a significant challenge.

HOW SHOULD WE HANDLE THESE CHALLENGES? (CONTD)

Strong mitigation is often the difference between a successful and a failed project. Our clients are increasingly asking us how they can build smarter and challenge norms.

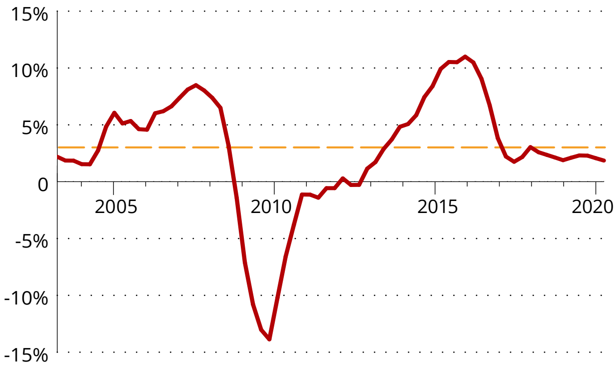
This can be achieved multiple ways including:

- **Strong client covenants**
- **Investing in Grade A design with clearly demonstrated value-add**
- **Sustainability as a core design and delivery tenet**
- **Challenge preconceived specification guidance; even beyond the new BCO 2023 guide**
- **Utilising MMC and off-site manufacture, where possible and efficient to do so**
- **Careful material selection**
- **Focusing on building and retaining a strong, experienced team**
- **Excellence in coordinated tender information**
- **Bespoke and appropriate procurement strategies – using hybrid and flexible models where appropriate – and timing that the market understands and accepts**
- **Warming the market up to ensure the necessary levels of contractor/supply chain engagement**
- **Appropriate levels of competition**
- **Equitable risk allocation**

Successful schemes tend to be a collaboration between the best players in the industry, working together to solve problems and deliver efficient, low carbon solutions that can attract quality tenants. To ride out the challenges of 2023, the most coveted business skills will be agility, adaptability, and the ability to engage quickly and effectively. Buildings need to be flexible, ambitious in their sustainability, and able to incorporate high levels of technology.

Over the longer-term, we believe we are witnessing a return to usual levels of growth and inflation taking place in a steady upwards trajectory. That said, the near-term future will no doubt be challenging as we adjust to this new reality, after a period of ultra-low interest rates and levels of inflation. In the face of the political and economic factors we've mentioned, we are focusing on the opportunities for innovation that always emerge in tough times.

TPI historical trends

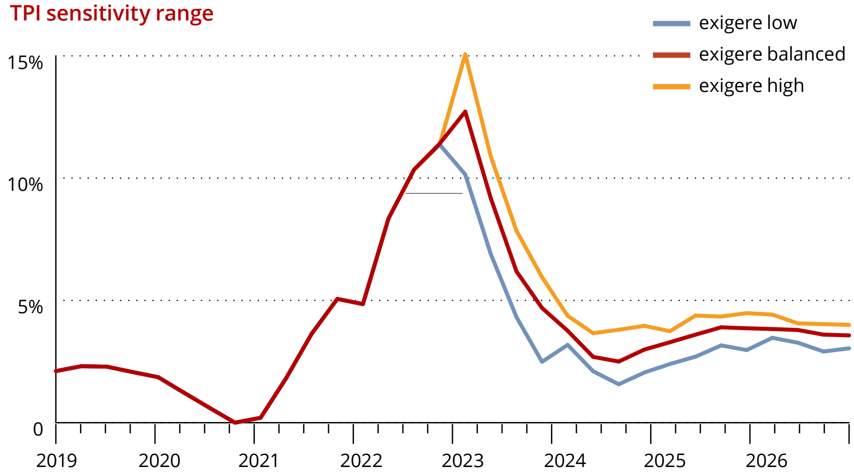


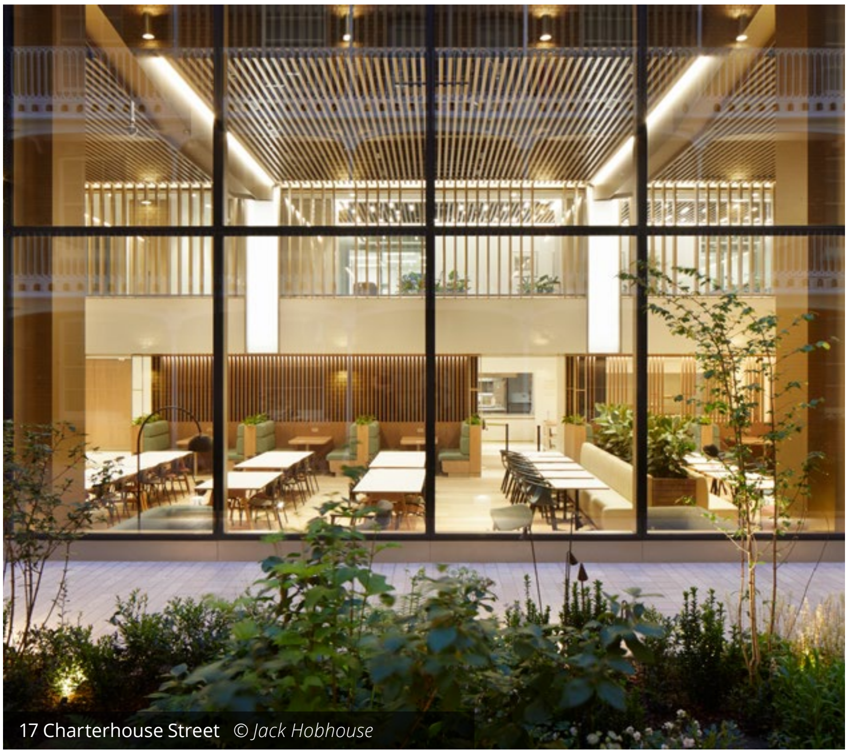
The last three years have not been normal.

Are we returning to a period of TPI stability and normality?

The long term average is circa 3%.

TPI sensitivity range





17 Charterhouse Street © *Jack Hobhouse*

WHERE ARE WE HEADED?

We continue to predict a significant slowdown in the rate of Tender Price Inflation for 2023, with levels returning to closer to the long-term average. Momentum from the high levels of inflation that we saw in 2022 continued in to the first quarter of 2023, but this has begun to slow with some prices beginning to correct. We anticipate the majority of the 4% TPI in 2023 to have occurred in the first half of the year with it moderating and flattening in the second half.

OUR PREDICTION FOR TPI IN 2023 +4.0%

Q2 2023 TPI FORECAST COMPARISON	BALANCED	LOW	HIGH
2022	11.4%	11.4%	11.4%
2023	4.0%	2.5%	6.0%
2024	3.0%	2.0%	4.0%
2025	4.0%	3.0%	4.5%

UPWARD PRESSURES

- CPI not falling yet, cost of living crisis and wage inflation
- Slowing, but continued material price increases
- Structural labour skill shortages/ productivity
- ESG/refurbishment; major infrastructure; life science; studios and data centres
- Demand for high-quality office space and flight to quality
- Restructuring of space due to change of working practice
- Tier 1 supply chain still selective and constrained in places
- Recovery of COVID losses?

DOWNWARD PRESSURES

- Banking crisis / squeeze on capital
- Some values have dropped dramatically
- Viability challenges
- Expecting CPI to drop dramatically
- Return to office gaining momentum, but tenant decisions on taking new spaces have slowed
- Future new build office development pipeline slowing
- Residential market remains very subdued
- Margins being squeezed

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AWARDS 2022 WINNER BEST USE OF TECHNOLOGY

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