

Q4 2023 Market Update

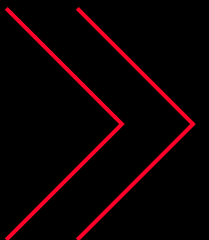
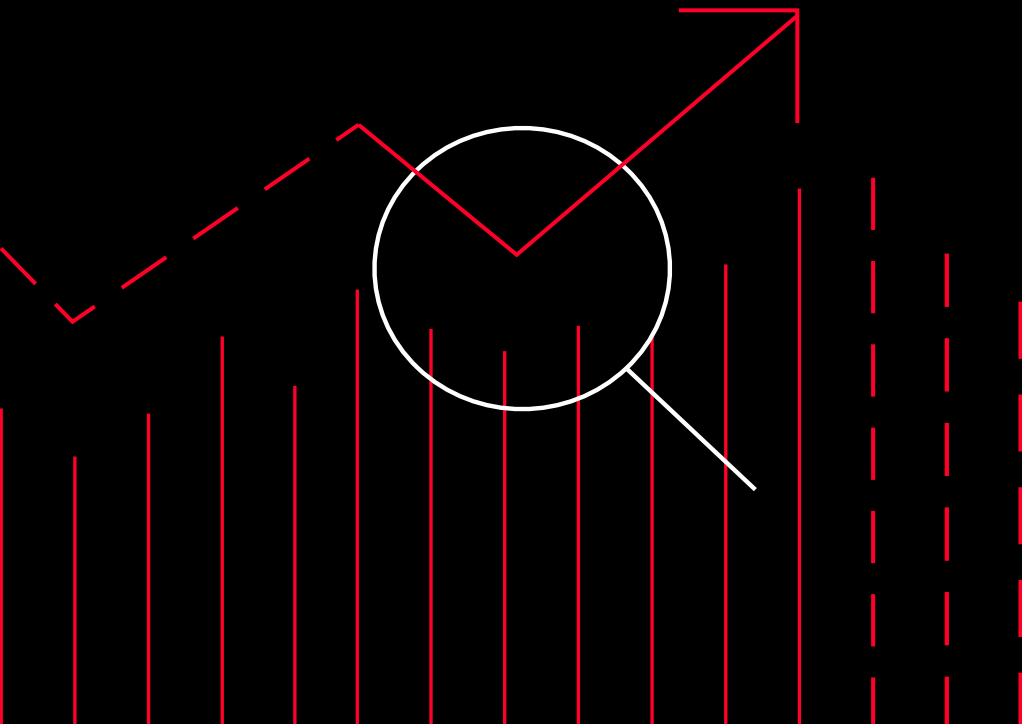
Developing commercial space in central London has never been more challenging, construction costs have rapidly increased over the past four years, c.30%.

Whilst COVID-19 and the war in Ukraine contribute to most of this increase, this is not the full story.

In this edition, we look at other cost impacts beyond core Tender Price Inflation, what we do about it, and where are we heading.

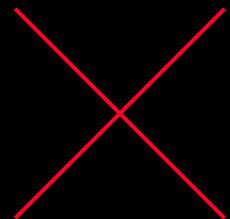
COVID-19 and the Ukraine war exposed weaknesses in global supply chains – triggering the energy price spike that drove, along with other factors, unprecedented inflation in construction material prices. With hybrid working now the norm, the role of the office is still responding, the role of the office continues to evolve.

Demand-side, the viability squeeze has also been exacerbated by weakening yields, muted occupier demand and high interest rates.



This is an unprecedented chain of events, and this is only part of the cost escalation story. In response to the climate crisis and building safety concerns, regulations have evolved rapidly over recent years. These regulatory developments, along with tenant demand-led changes, have raised central London office specification, leading to a two-tier office market - with a resulting impact on baseline construction costs.

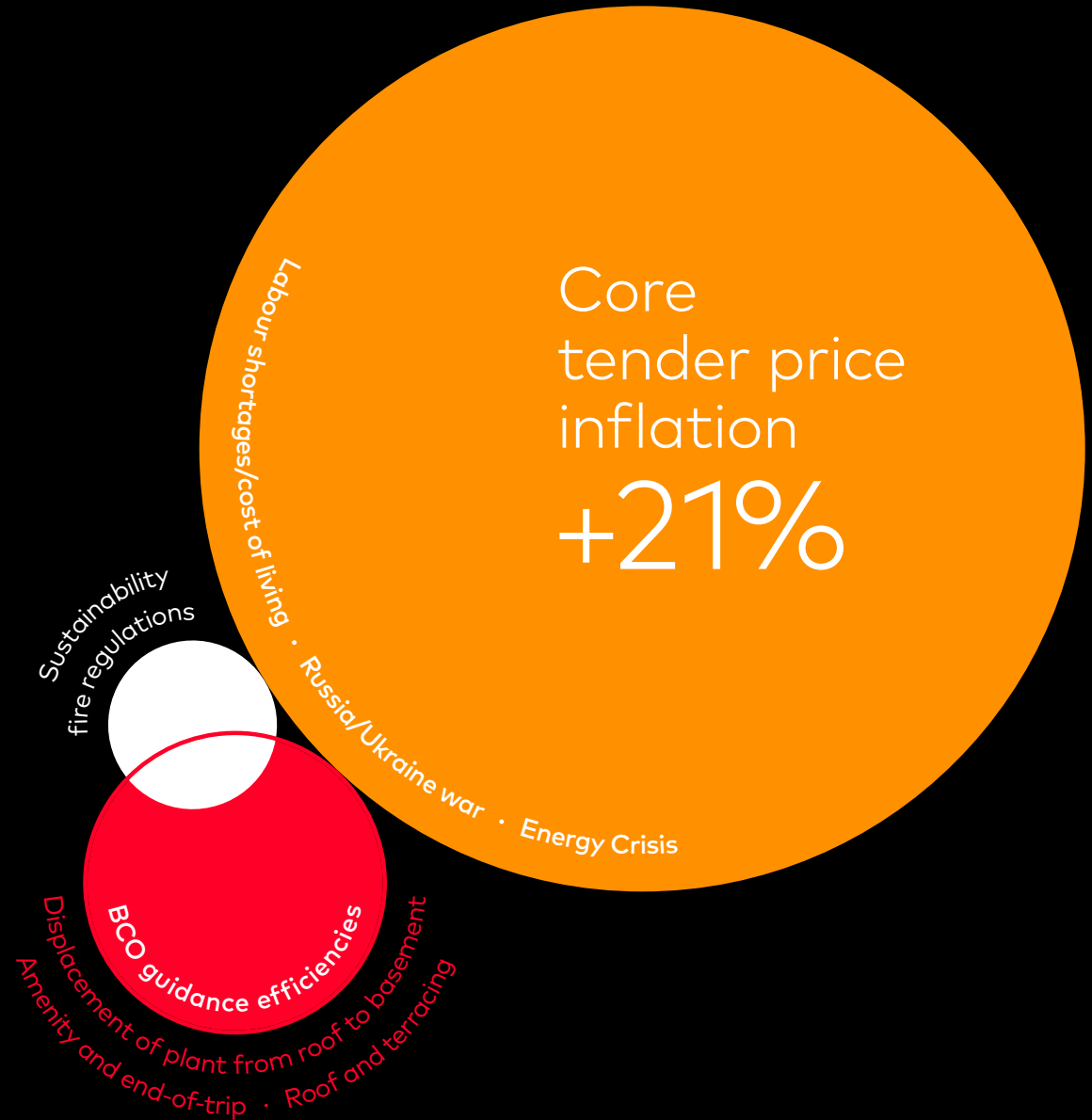
In this market update, we discuss the impact these events have had on construction costs and consider what can be done to overcome these exceptional challenges and improve project viability.



**Central London office
cost escalation
Q1 2020 - Q1 2024**

**Regulatory
+3-5%**

**Evolving
design
+6-8%**



Weighing up the impacts

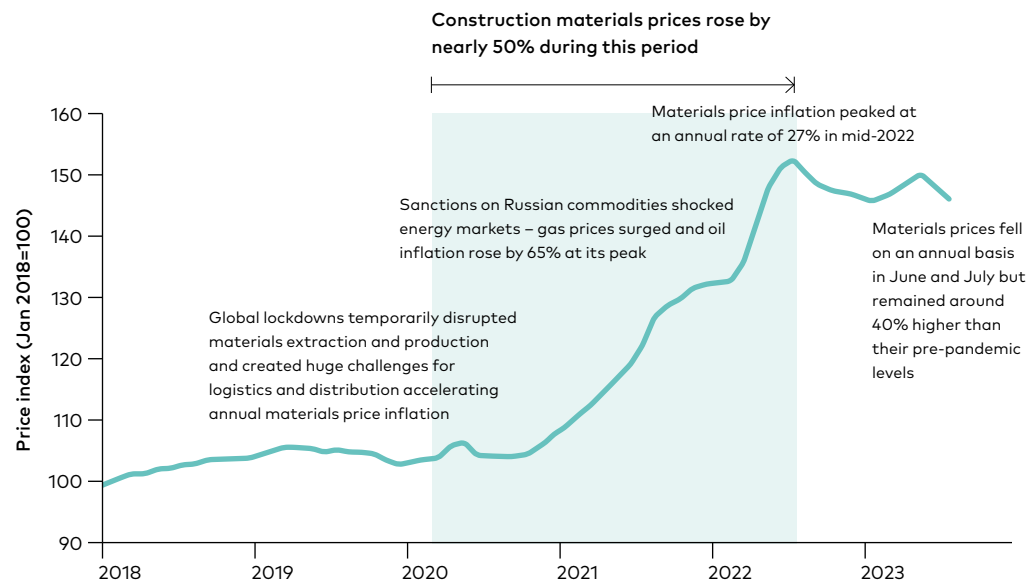
Unprecedented pressure on direct costs

COVID-19 and the Ukraine war pushed global supply chains to breaking point. Lockdown-induced gridlock revealed significant vulnerabilities in the model we rely on to meet our need for raw materials, components and manufactured construction products. The knock-on impacts from a manufacturing pause and resulting logistical challenges triggered the start of the inflationary spiral in the first half of 2020, but, as we now know, that was just the beginning.

Construction cost inflation has recorded double-digit growth annually since 2020. Materials cost inflation has been the primary driver. Today, the materials component of a construction project typically costs 30% to 40% more than it did in January 2020.

Wage inflation has been less of a factor relative to the extreme uplifts in materials costs. Construction labour costs rose by around 14% from the start of 2020 to mid-2023, less than a 21% increase across all industries. Construction sector wages have been less responsive to the cost-of-living pressures facing the wider economy – in an industry with such a fragmented supply chain and high levels of self-employment, demand and capacity tend to have the biggest impact on wage negotiations and construction workers have taken a larger pay cut in real terms than workers in other sectors.

Will stronger wage inflation feed through to industry pay packets? Yes, but whilst it is having an impact, industry vacancy rates are now falling and the recent reduction in core consumer price inflation will help alleviate pressure. Construction wage inflation has slowed to 5.7%.



“Today, the materials component of a construction project typically costs 30% to 40% more than it did in January 2020.”

Will core construction cost inflation ease in the near term? We expect a significant slowdown in 2024 but upside risks still remain, and significant deflation is unlikely. Manufacturers and contractors absorbed some of the inflationary impact of the energy price shock and this will influence pricing decisions over the next 12 months.

Recent months have also seen the impact of, first COVID, and then the energy crisis taking their toll on some significant players in the contracting market which will put further strain on the wider supply chain.

Rapidly shifting policy environment

Building regulation took a step on its 'net zero ready' pathway. Changes to parts L and F in 2022 sought to improve operational carbon performance through external fabric and energy efficiency improvements, along with enhancements to indoor air quality.

The GLA's 2021 London Plan came into play, introducing a requirement for development in the capital to be net zero, delivered in part, through a significant improvement in energy performance relative to building regulations. Developing greener spaces, incorporating more cycling provision and a commitment to monitor operational performance, were all key policy areas. We have seen a trend towards increased landlord areas, including end-of-trip facilities and reception/amenity spaces in the last five years, which have doubled in size since 2017 – from 1.5% to 2% of gross internal area six years ago to 3% to 5% today.

The Building Safety Bill (BSB), which predominantly seeks to strengthen accountability for structural and fire safety in buildings that are deemed to present greater risk, gained Royal Assent

in April 2022. Implications of the BSB are wide-ranging.

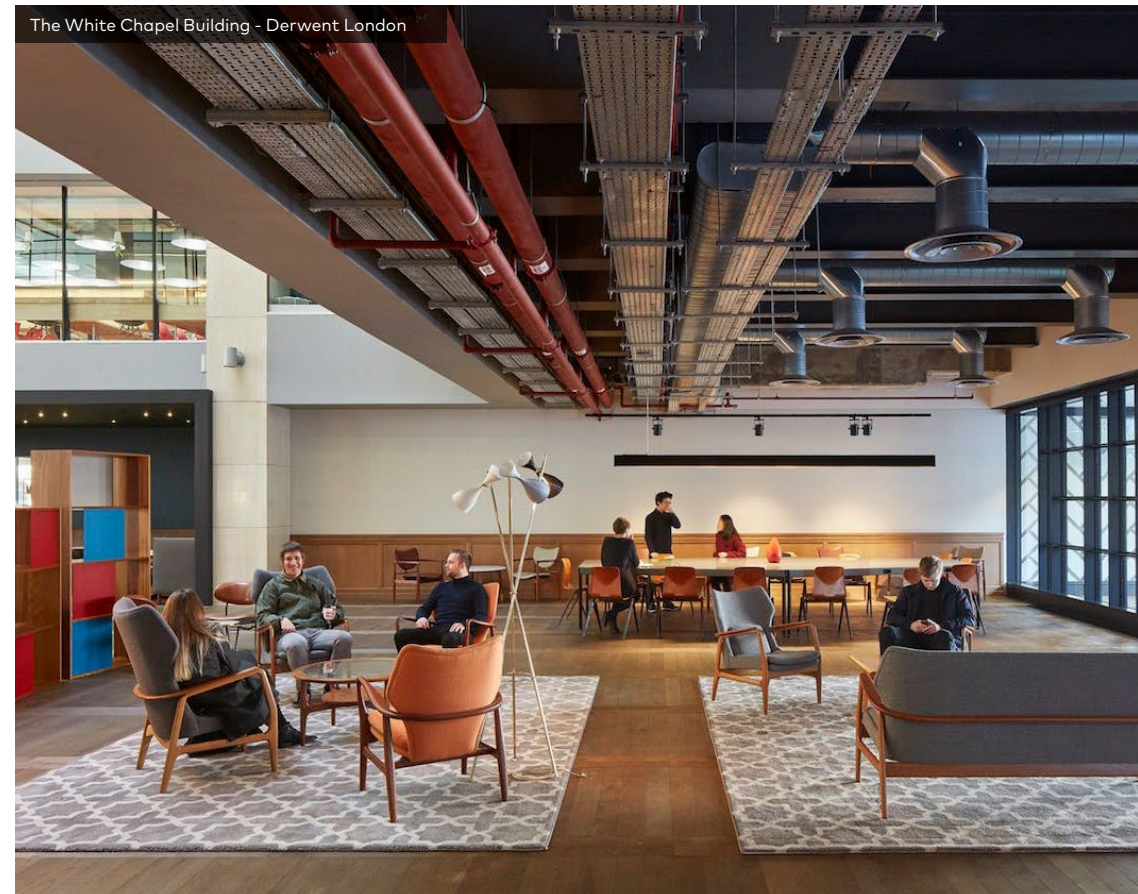
From a construction cost perspective, the need for duty holders to maintain a detailed 'golden thread' of information digitally throughout a development's lifecycle is one of the most significant.

This intervention alone is expected to cost the industry nearly £365m over the next 15 years under a balanced assumptions framework, according to government analysis. It's a significant additional cost layer when viability is already stretched to the max.

BSB requirements largely, but not exclusively, apply to 'higher risk buildings', defined as developments over 18m containing at least two residential units. Some aspects of the bill apply to relevant lower-rise development and, even where the bill doesn't apply, compliance with relevant safety regulations is now, quite rightly, tested with greater rigour. The Fire Safety Regulations Approved Document B introduced in December 2022 has further impacted MEP systems such as the requirement for dedicated fire evacuation lifts, more stringent design and certification requirement for smoke extract and ventilation systems.

"Landlord areas, including end-of-trip facilities and reception/amenity spaces have doubled in size since 2017."

Plus, of course, in residential development, there is the second staircase - first mandated by the GLA for buildings over 30m back in February before the DLUCH swooped in, lowering the threshold to 18m in July. Granted, this is not directly relevant to commercial development, but it is a masterclass in disruptive policymaking which undermines general industry confidence and impacts decision making.



Shifting policy challenges

LETI Design Guide

issued – setting best practice embodied carbon targets for commercial offices at <math><600\text{kgCO}_2/\text{m}^2</math>

New London Plan 2021 – net zero carbon development and enhanced energy efficiency requirement relative to building regulations, operational use monitoring, urban greening, increased cycling provision, higher biodiversity net gain requirements

Building Safety Bill gains Royal Assent – fortifying regulation and increasing transparency through 'golden thread' requirements

Interim update to BCO 2019 Specification – including reduced density requirements, greater flexibility in structural design, 5-star NABERS UK target for new buildings, lower power and cooling loads

Future Buildings Standard – due to come into play in 2025

Environment Bill gains Royal Assent

Part L&F Building Regulations Update – strengthening energy efficiency performance and increase ventilation requirements

Second staircase essential in buildings over 30m containing at least two residential units – mandated by GLA in February and nationally DLUCH in July

UKCA mark in and EU CE mark out – possibly!

Minimum Energy Efficiency Standards due to tighten EPC C in April 2027, rising to EPC B in April 2030

BRE's draft Net Zero Carbon Building Standard out for consultation

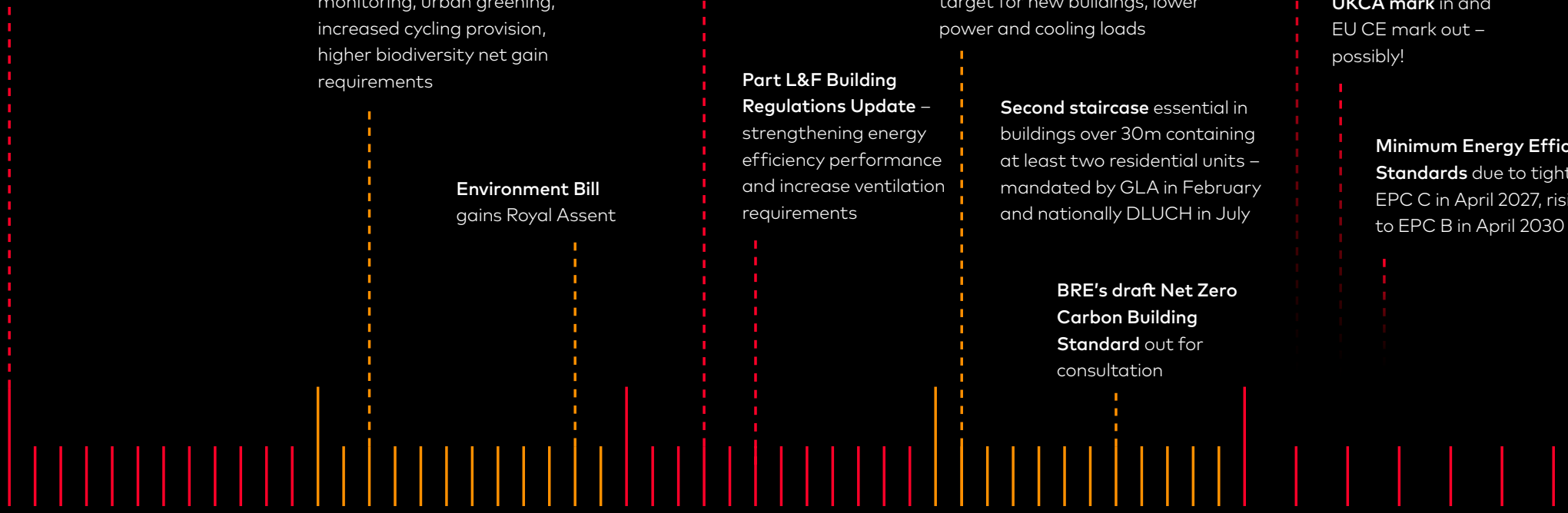
2020

2021

2022

2023

2024+



Industry-led change and tenant demand



Castle & Fitzroy House - Capreon

Best practice industry guidance is also evolving. LETI published its seminal design guide in 2020 to establish an initial view on embodied and operational carbon benchmarks across sectors and the BCO introduced its 2023 specification guide earlier this year in response to the unprecedented influences affecting building design.

Changes include a relaxation in occupancy density design requirements, minimum sustainability targets of BREEAM Excellent or 5-star NABERS UK for new buildings - reduced power and cooling loads and more flexibility in the range of structural spans for office space.

Collectively these changes encourage more efficient design than ever before. A combination of reduced power and cooling loads, a reduced structural grid, sensible floor to ceiling heights, plus lighter weight frames with more efficient foundations where appropriate, can have a big collective positive cost and carbon impact.

Tenant-led change is also a factor. The office experience matters more than ever and there is a drive to deliver best-in-class facilities. Provision of shared roof terraces and other green spaces often exceeds levels mandated by the London Plan's Urban Greening Factor, often reducing net internal area, adding to roof complexity and further increasing cost. Simple roofs are a thing of the past.

In the pursuit of excellence and differentiation, reception areas with shared workspace and retail use, separate amenity space and enhanced end of journey facilities are all getting bigger, with extra cost and impact on NIA.

A demand-led push for low carbon and more sustainable materials can also nudge construction costs up. In high-specification schemes, low carbon substitutes of sufficient quality can be more expensive and the reuse of materials such as steel does not necessarily drive cost or programme benefit. However, these factors may be somewhat offset through simplification of design, dematerialisation, and the careful selection of materials.

The impact of uncertainty

Against this extraordinary backdrop, there has been a lack of strong leadership by government. In less than four years, we've seen the appointment of seven different construction ministers - most with little background industry knowledge - which has resulted in confused and inconsistent policy decisions, making the already difficult development challenge that little bit harder.

"Design teams are trying to deliver optimal carbon solutions without a clear understanding of how impacts will be assessed by planners."

U-turns on planning reform, the product standards testing regime and lack of responsiveness to the skills challenges the industry faces adds to the uncertainty and can have an indirect impact on supply chain sentiment and appetite for risk.

The Secretary of State's recent rejection of Marks and Spencer's application to redevelop its flagship Oxford Street store, partly on the grounds that a whole life carbon assessment favouring redevelopment over refurbishment was inadmissible due to the fact carbon measurement tools are still developing, exposes another significant issue. If following industry best practice to quantify the relative carbon impacts of different design options isn't considered sufficiently robust to support a planning application and government guidance on more robust carbon quantification simply doesn't exist, design development through the planning process becomes a very complex and uncertain proposition. Design teams are trying to deliver optimal carbon solutions without a clear understanding of how impacts will be assessed by planners.

Challenging what was the norm

In this exceptional environment, it is essential that we challenge the norm – push boundaries and seek better solutions. Scheme viability is under more pressure than ever, and we need to work collegiately to reduce costs without compromising value.

Project teams and cost consultants must drive for the extra 1 or 2% and work harder than ever to challenge specification and drive area to deliver what occupiers really want by understanding, prioritising and delivering the target markets' key priorities, rather than potentially repeating what's been done in the past.

Standard specifications and guidance have an important role to play, but they can be misused, or misinterpreted, if taken as a development rulebook from which you should not deviate without very good reason. This can lead to overspecification and suboptimal commercial solutions. The BCO is first to state it does not advocate any design solution and that its guidance should be interpreted by qualified, experienced designers within the context of each project's unique conditions and parameters.

Whether it is challenging lift waiting times, materiality, or exploring if an extra column or two really does diminish the ability to let a space, a frank appraisal of whether the specification is right, or needed, can help to ensure teams focus on the areas that truly add value.

Designing in a degree of flexibility and resilience is sensible, but providing additional structure for future scenarios which are unlikely to occur, is not. The same can be said for MEP systems. Where structural loading is concerned, the BCO's Guide to Specification 2023 encourages more efficient design, but design teams can go further. Challenging blanket loading guidance, reducing requirements for partitions and designing plant rooms for actual plant, can make a big difference.

Accessible roof terraces are clearly desirable for tenants, but the true cost and carbon of this space should be clear to allow developers to make considered decisions.

The GLA's current area-based policy on cycling provision is a pertinent example, linking provision to floor area without consideration of likely demand from occupiers.

Typically housed in locations used for necessary back of house functions and plant, cycle provision can reduce building efficiency and lead to the overall building size increasing. Basements have a high embodied carbon footprint and the drive to reuse existing basement space is strong. It is therefore somewhat counter-intuitive that absolute basement size is growing, in part due to the need to locate plant in basements, to enable greater activation of valuable roof space, but also due to the prescriptive provision of end of journey facilities. Bigger basements in-turn increase structural complexity – meaning more cost, and crucially, more carbon.

If provision is well utilised and sought after, these opportunity costs matter less, but if it is not, there's surely an issue? Anecdotal feedback from facilities managers highlights problems due to lack of use. In these situations, additional carbon and cost impacts incurred simply to tick a planning box should really matter.

"It is therefore somewhat counter-intuitive that absolute basement size is growing."



Getting back to basics

Taking time up front to get the basic fundamentals right, in detail from the outset, will pay dividends. It may sound obvious, but in a resource-constrained marketplace, without proactive leadership this can sometimes not happen.

Teams need to be challenged in the right way, at the right time. Overspecification can occur when teams are pressed and unable to dedicate time to resolving the challenges that lean and efficient design ultimately presents. Keep design solutions as simple as possible and build less, as quickly as possible - through efficiency. The optimum speed to market is likely more key to viability than construction cost itself.

We fully advocate a fully collaborative design process from the outset, designing the right solutions for the scheme and always measuring in a qualitative manner against an agreed 'bunker' cost and carbon model. This will facilitate that informed decisions are made, all with the same goal of making the project happen successfully, delivering better solutions more efficiently.

As we know, it's no longer just about time, cost and quality. As the industry is learning, carbon is now a primary consideration that should influence design and shape decision making from the outset. Not getting the fundamentals right in the first place, and instead attempting to overlay carbon considerations once the design has developed, will ultimately increase cost and lead to suboptimal solutions, assuming the planning hurdle can be overcome.

Sustainability shouldn't ever be about ticking boxes. The underlying principle should be less is more – build less and build efficiently and quicker. Reuse materials, introduce carbon saving measures, embrace technology and always consider refurbishment seriously – where it makes sense to do so.

"Attempting to overlay carbon considerations once the design has developed, will ultimately increase cost and lead to suboptimal solutions."



76 Upper Ground - Stanhope

Buying smarter

Procurement strategies must evolve to reflect the challenging development backdrop and delivery constraints we currently face. Recent events have tested supply chains to their limits and it is vital that fundamental design and procurement decisions are cognisant of wider macroeconomic and geopolitical developments.

A nimble, innovative and pragmatic approach, underpinned by close supply chain proximity, can help to optimise procurement strategy, certainty on delivery, and mitigate market challenges. Adopting the ethos advocated by the Private Sector Construction Playbook, for example, can build a robust, collaborative delivery framework by building effective partnerships, supported by early contractor and supply chain engagement.

Where are we heading?

Immediate cost pressures have eased and levels of tender price inflation are normalising, with modest inflation expected to persist over the next 12 months and, with the introduction of the Future Buildings Standard anticipated in 2025 and a general election, the pace of change is set to be maintained.

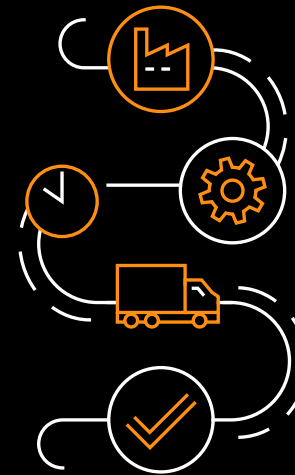
Energy price stability remains a risk as winter approaches. Gas prices have fallen from the exceptional highs seen in 2022 – currently down by around 80% on last year, but still over 150% higher than in early 2020. Storage capacity across Europe is relatively full, yet markets are jittery.



Oil prices have also appreciated in recent months on the back of cuts to OPEC+ supply. Prices currently hover around the \$90 per barrel mark.

Industrywide activity is set to contract as expected in 2023. The Construction Product Association's latest forecast suggests output will fall by 7% this year. Commercial offices activity remains subdued relative to pre-pandemic levels, but whilst vacancy levels are at an all-time high, there remains demand for high quality central London office space. Uncertainty remains with CPI falling and interest rates looking to have peaked. Prime yields have stabilised in the West End and city markets, and some are starting to question whether we are nearing the bottom.

Three quarters of central London new office starts were refurbishments in Q1 2023 – a 48% increase on 2015. We expect this trend to continue, driven by the sustainability agenda and the reaction to the MEES regulations, plus the ease and speed of securing planning consent for refurbishment projects over new build permissions.



Competitive pressure will strengthen over the next 12 months and contractor appetite for certain schemes will increase. A return to the aggressive competition on price, typical in previous downturns, is however unlikely. The supply chain is entering this downturn with weakened balance sheets and insolvencies are already at levels not seen since the financial crisis, with long established key supply chain members being impacted.

COVID-19, however, has created a huge development opportunity in the sense that workspaces are now, more than ever, a hub for company culture – for collaboration and innovation. This has increased their value. Occupiers are, in short, willing to pay more for location and space that successfully meets these requirements.

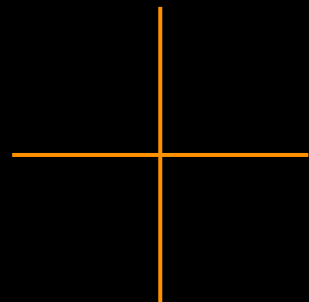
The opportunity is there, but the development backdrop remains challenging. It is therefore vital for us to challenge the norms that we subconsciously accept and adhere to. It's time to rip up the rule book, to challenge, and to make conscious evidence-based decisions to drive true value and fully maximise development potential.

"The supply chain is entering this downturn, with long established key supply chain members being impacted."



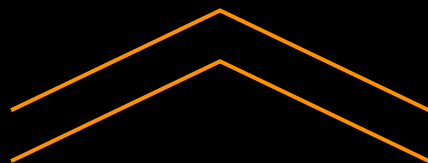
Our prediction
a marked
decrease for
TPI in 2024

+1.5%



Q4 2023 – December:December change (%)

SENSITIVITY RANGE	2021	2022	2023	2024	2025	2026
LOW			3.75%	0.0%	1.0%	1.5%
BALANCED	5.1%	11.4%	4.0%	1.5%	2.5%	3.5%
HIGH			4.0%	2.5%	3.5%	4.5%



Upside inflationary pressure

CPI falling but remained at 6.7% in October.

Cost of living crisis and wage inflation continues - higher than CPI.

Structural labour skill shortages/ productivity.

Supply chain still selective and constrained in some areas, e.g. MEP.

Pockets still struggling post COVID losses.

ESG/MEES refurbishment, infrastructure, life science and data centres.

Demand for high quality office space - flight to quality.

Downside inflationary pressure

Interest rates held at 5.25% in October, but squeeze on capital remains.

Commercial values dropped dramatically.

Significant viability challenges.

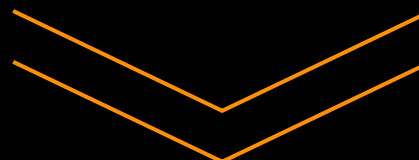
Return to office gaining momentum, but tenant decisions on taking new spaces have slowed.

Future new build has slowed.

Residential market is very subdued.

Margins being squeezed.

Input and material prices falling (fuel, energy, steel and timber).



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