Commercial property in London: what matters now?

During the summer and early autumn, we spoke to a cross-section of our members who own and develop commercial property in Central London, alongside our members who are their advisors and tenants, to understand the main issues currently facing the sector and the implications for the wider public policy challenges facing London.

Introduction

The Coronavirus pandemic has had a profound impact on commercial property in and around London's Central Activity Zone (CAZ).

The CAZ has seen an unprecedented drop in footfall, from a combination of dramatically fewer office workers coming to their workplace and fewer international, UK and local visitors. West End footfall was down 87% year on year in the second quarter . VisitBritain show that overseas tourists spent £7.4bn less on goods and services in London's economic and cultural centres throughout 2020, while domestic tourists spent £3.5bn less, a combined total of £10.9bn .

Some businesses have been prohibited from opening at different times through 2020, while others have suffered severe legal or practical constraints. The short-term impact has been greatest on the leisure, hospitality, retail, and cultural sectors where demand, a few pockets aside, has shrunk significantly and businesses have generally had to trade on a constrained and sporadic basis. Many businesses in these sectors, facing no or little income, have not paid their rents. While demand will return, the pace and level is uncertain and the number of trading businesses which will survive the 2020 recession is similarly unclear.

The impact of shut or sparsely attended offices has been severe on those businesses in the CAZ that rely on office workers for their income; and more Londoners can work at home than workers in any other UK region . It has been more muted in the short-term on office owners – as many businesses have been able to continue trading with their staff working at home and thus meet their rental commitments. But while a few have prospered through the lockdowns most have found trading tough and are looking to reduce their costs, with their property leases being part of this calculation.

These short-term pressures are playing out as part of a much broader debate on the future of work and the future of cities; a debate of central importance to the future of London, one of the world's most successful commercial centres.

In conversations with our members no-one sees an entirely remote on-line future: a company cannot build its DNA solely through a combination of Zoom and Teams calls. Businesses need collaborative working space for their people, their clients and stakeholders; younger people, in particular, need the interactions of an office to develop and thrive. Equally, very few expect to return to a culture of five days a week office-based working, and there is accordingly likely to be less demand for solo desk space. Quite where the level will settle between these two poles is uncertain.

This was changing before the pandemic. Structural changes were, as ever, taking place in London's commercial property market. Online retail was on the rise, with implications for physical retail, showrooms, and logistics. Flexible office space, both in the sense of commercial terms (firms wanting the freedom to move their space up or down) and the use of space (collaboration areas rather than fixed workstations, and more flexible working) was on the rise.

The American futurist Roy Amara argued that we tend to overestimate the effect of a technology in the short run and underestimate the effect in the long run. Unpicking the difference is critical to understanding the city-wide response to the pandemic. Which trends are being accelerated; which have surged but will fall back; and what is new? And, of course, we have agency here. As important a question is: do we want to facilitate these movements or take determined action to stop them?

These decisions matter for the city and country as whole. London represents almost a quarter of the UK's GVA, with around 14% of the population and 17% of the jobs. In normal times it generates the largest regional tax surplus, nearly £39bn in 2019 and is one of only three UK regions to be in the black . Commercial property is a vital part of this value generation -- paying over £8bn in business rates alone annually, over a third of the total collected in England . Much of this economic value add comes from the concentration of activity in the CAZ – the agglomeration effects of so many businesses being located so close to each other.

The commercial property sector has played a critical role in supporting this success: it provides the spaces where we work, shop and store goods; where we enjoy the city; and where visitors, from the rest of the country and globally, come for work and pleasure. And much of the sector is owned by pension funds and similar, long-term saving vehicles, making it an important part of millions of people's financial planning.

So the decisions that will be made by those that own and manage assets, and who determine the development pipeline for the city, who are facing a host of short-term challenges and medium-long term uncertainties, will be central to London and the UK's continued prosperity.

What matters in the short term?

…rents need to be paid. Those who genuinely can't pay, won't pay. Many landlords have worked constructively with businesses whose revenues have collapsed to put in place special measures. But those who can pay should not be able to use measures designed to protect the vulnerable to escape their obligations. Similar issues apply to the misuse of Company Voluntary Arrangements. The rent shortfall in the UK since March is estimated to be more than £3bn, with this deficit potentially growing to £4.5bn by the end of December . The government needs to act early in 2021 to prevent a wave of litigation which will hit the UK's international reputation as a safe investment location.

…business rates relief needs to be extended. The 100% relief for businesses in hospitality, leisure, and retail should continue for 12 months beyond April 2021 – freezing the multiplier isn't enough. This will support tenants hardest hit by the pandemic and help shore up their cash flow. And the government needs to set out options for longer term reform which will fix this broken tax.

…licencing flexibility needs to be maintained. Temporary measures around Covid – such as al fresco street dining – need to expand rather than contract as businesses struggle to recover and recapitalise over the next few years. It is critical that the boroughs, London, and Central Government recognise this and act accordingly – this will be particularly important for the emerging night-time economy.

…planning needs to be simplified. The flexibility of use classes introduced by government through the E class order has been very helpful. This simplifying approach should also be applied to the process by which changes to extant planning permissions are be made.

…vigorous support for meanwhile use. Ground floors in the CAZ are increasingly gap-toothed – the GLA's High Street recovery plan, which includes support for meanwhile uses, needs to be vigorously implemented, including in particular the GLA setting up and maintaining a Meanwhile Use Register of tenants looking for temporary space and working with the boroughs to act as a broker between landlords and potential users of space.

…footfall needs to be encouraged to return to the CAZ. As 2021 sees growing confidence and vaccination take-up reducing the threats of Covid, the CAZ needs a campaign to attract workers back to the office; to attract visitors from the UK and Europe back to London; and globally, so that all can enjoy what the capital has to offer. The CAZ has strong local champions in the Business Improvement Districts (BIDs), as well as many strong local institutions. These need to link closely to the Government's planned refresh of the GREAT campaign; getting people back onto public transport; and reopening air corridors with robust testing, and more effective test and trace in the round. And emphasising the importance of the London brand to Britain; and of London's economic success to that of the whole country – in ways that will play well with the rest of the country

…we need to continue to invest in improving the experience. Innovative ways in which the private sector can be incentivised to invest in public realm, perhaps linked to local BIDs, are an important part of improving attractiveness and sustainability.

…turbulence will continue. Many normally sound businesses which have got through 2020 will be indebted and have stressed balance sheets – meaning they will be looking to cut their fixed property costs in the short-medium term. The transition to new ways of working and the right space to support this will face a headwind of cost cutting in the next few years.

What matters in the medium term?

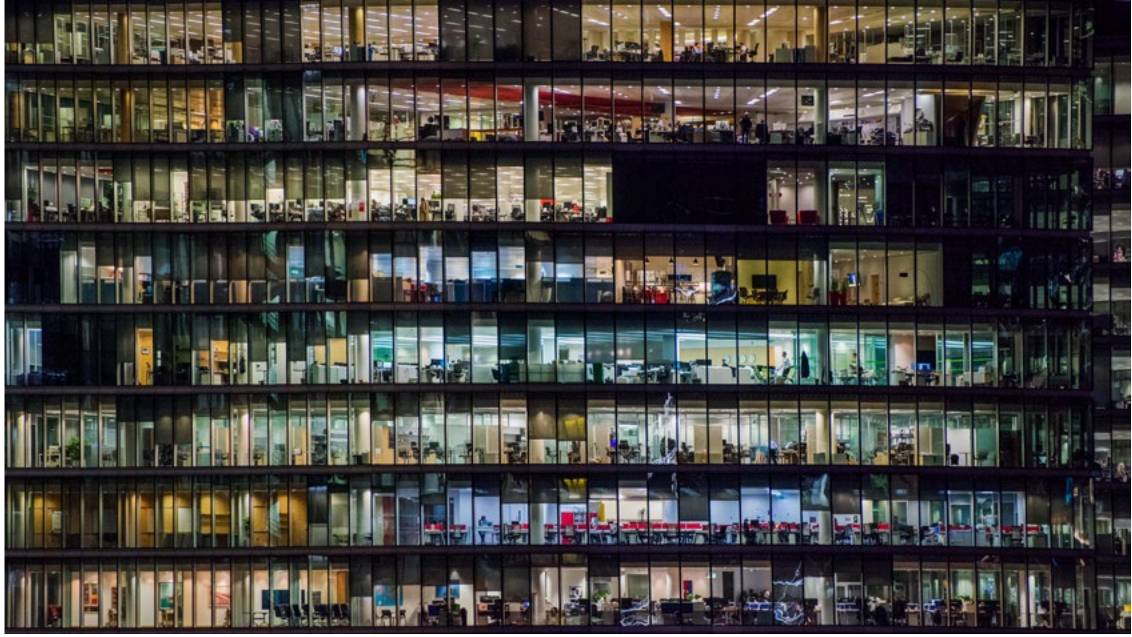
…continued demand for offices in the CAZ. There has been some discussion about local hubs as opposed to central large offices, to shorten commutes. The practical challenge is that this requires the appropriate team members to live locally in a city where the transport system is geared towards radial commuting. The same would be the case for clients. Of course, lower cost areas near to and well connected to the CAZ, such as Croydon and Stratford, will continue to be attractive to many businesses. But equally, it may be that if businesses want smaller core premises, a CAZ location will become more affordable.

…increased demand for flexibility around terms for office space. Options for shorter leases (noting that fit out costs can make this less attractive) and variability around amount of space, with it flexing up or down according to need around a corporate core. This may confer some competitive advantage on landlords who have a large, geographically concentrated portfolio which can accommodate such flexibility – and who can more easily manage the transaction costs of more bespoke contracts.

…demand characteristics will vary by sector. Law firms, for example, are more likely to return to traditional working patterns which have served them well compared to tech companies where remote working has proved effective and fits with their corporate culture.

… demand for hotel-like serviced offices – at a range of price-points – is also likely to rise, accentuating the pre-pandemic trend.

…demand for more sustainable space will continue to grow. The cost pressures on business are unlikely to be met by a dilution of focus on the Environmental Social and Governance agenda – from employees as well as investors; the big issue being whether occupiers are willing to pay a premium for higher spec development.



…demand for logistics space will continue to grow. There will need to be more space for last mile aggregation and distribution as demand increases and at a time when many logistics firms are being pushed out of London and into the wider South East due to rising rents and shortage of space. Both factors are increasing delivery mileage and associated environmental impacts, therefore issues such as freight consolidation and active management will become more important to policy makers.

…moves to turnover linked leisure/retail rents. Trends towards rents having at least an element of turnover as part of the mix are likely to increase. This is easier for some uses, e.g. hotels and restaurants, than for retail space which drives online orders. This it is likely to be evolution rather than revolution, and will involve sharing both pain and gain, those asset managers who can deliver innovative products are likely to have a competitive advantage.

…this will all have implications for investment. The market will need new models for valuation, beyond the strength of covenants.

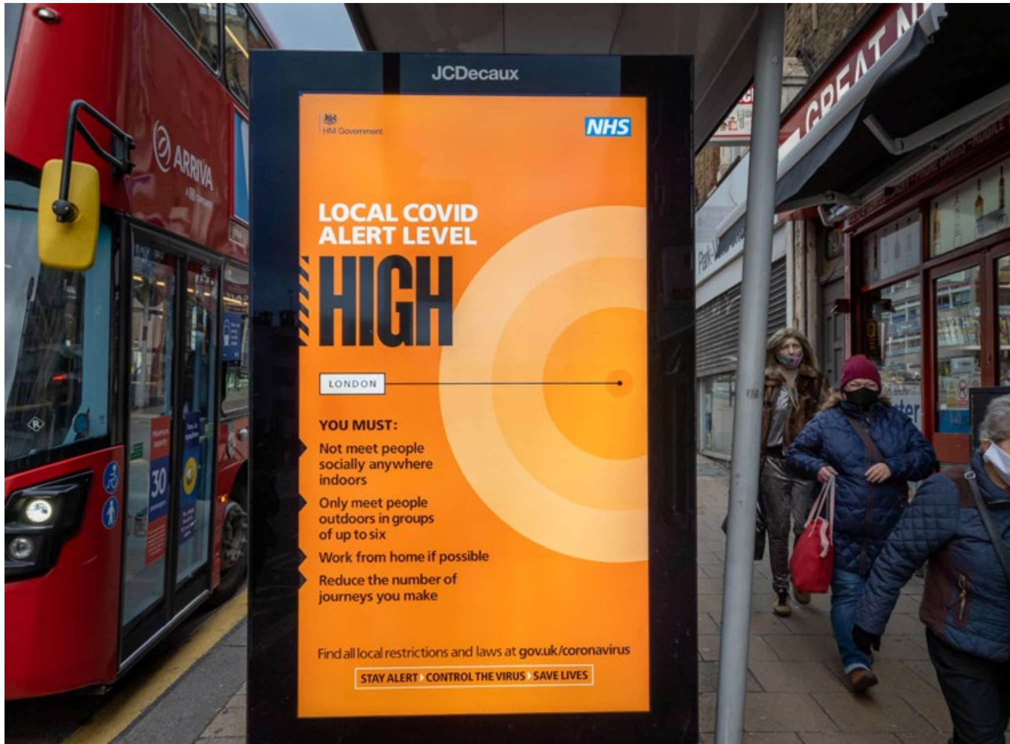
…implications for tax policy. Business rates, based on old-style fixed rental values, will become even more detached from reality as new, more variable rental models become more common; and the case for radical reform is strong. Similarly, the recent broadening of Stamp Duty should be reconsidered for the trading conditions of the 2020s. And VAT-free shopping for overseas visitors needs to be maintained – otherwise the pace of recovery for tourism risks being severely hit.

…planning policy reform needs to support flexibility and change rather than subvert it in practice. The Government's White Paper has great potential – but also many unanswered questions, notably around the new system of developer contributions to infrastructure and affordable housing and the role for London Government. The GLA could, for example, be given greater powers and responsibility to drive development in growth areas. And national policy must provide clear guidance to authorities on maintaining an appropriate land supply for commercial development to maintain employment growth and recognise and support the need for increased logistics infrastructure and space.

…it is critical that London's transport infrastructure is maintained. London is reliant on public transport to get people to and from the CAZ. Welcome as some of the initiatives around active travel are, this reliance will continue as demand to get into the centre returns. However, demand is unlikely to reach the levels of 2019 for some time – more flexible working will likely mean fewer work related journeys while tourists will take time to return. This creates a significant medium-term challenge for Transport for London (TfL) as its budget has been very highly geared to its farebox, with over 70% of total revenue coming directly from passengers – a much higher percentage than in other world cities: for example, it is less than 40% in New York or Paris . The costs of the tube and rail network are largely fixed in the medium term, although there is more scope to cut bus costs; but it is vital that London continues to have a high frequency mass rapid transit service. London government, TfL and central government need to work together to put in place a sustainable package of measures to plug the gap in TfL's revenues.

…similarly, it is vital that we continue to invest in digital infrastructure. While London's data network has performed better than many would have expected, demands will continue to rise and the GLA, boroughs and Central Government need to continue to work together to expand full fibre and roll out 5G.

…and a lot depends on the facts – and perceptions around – the Covid 19 pandemic. Is it a once in a hundred years event like Spanish Flu or will we be planning and preparing for a similar event in the near-term?



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London First was set up by business leaders with the belief that by harnessing business assets we can drive positive change. We operate as a business campaigning force, with around 200 members, and are uniquely placed to champion the city:

- We've done it before: back in the 1990s, London's prospects looked bleak. Business leaders came together to lead when others wouldn't;
- We've achieved a lot: over the past three decades, we've campaigned for the creation of the office of London Mayor and Transport for London, for Crossrail, for congestion charging and for expansion at Heathrow; we incubated Teach First and created the UK's largest annual jobs and careers fair for school leavers, Skills London;
- We give London's employers a powerful voice, prioritising the critical interventions needed to keep our capital competitive and connecting with allies to create solutions that help our country succeed as one.

In response to the pandemic, we're stepping up once again. With our members – and the millions of people they employ in the UK – we are pursuing an agenda that will keep London at the forefront of global business, working with and for the whole UK.

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