CHAPTER THREE

HOW WILL THE FUTURE BE FINANCED?

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IDENTIFYING COMMERCIAL OPPORTUNITIES AT A TIME OF FUNDAMENTAL CHANGE

Finance is evolving as developers discover new ways to fund projects and global investors target commercial property

THE BRIEFING

There has been a fundamental transformation of the financing model for commercial property.

Developers are increasingly looking for alternative sources of finance.

Insurance companies and pension funds are financing key developments.

Global investors, including sovereign wealth funds, are major buyers of commercial property.

The difficulties in the debt markets are still having far reaching effects across the UK property industry, not least in the development market. Developers are finding it hard to raise funds from traditional lenders and, as a result, have been forced to scale back their activities. So what innovative ways can companies use to access new funding?

Before the downturn a considerable amount of development was funded by debt financing. A recent report from the Property Banking Forum (PBF) found that while debt is still available for developers, pre-letting is nearly always a prerequisite.

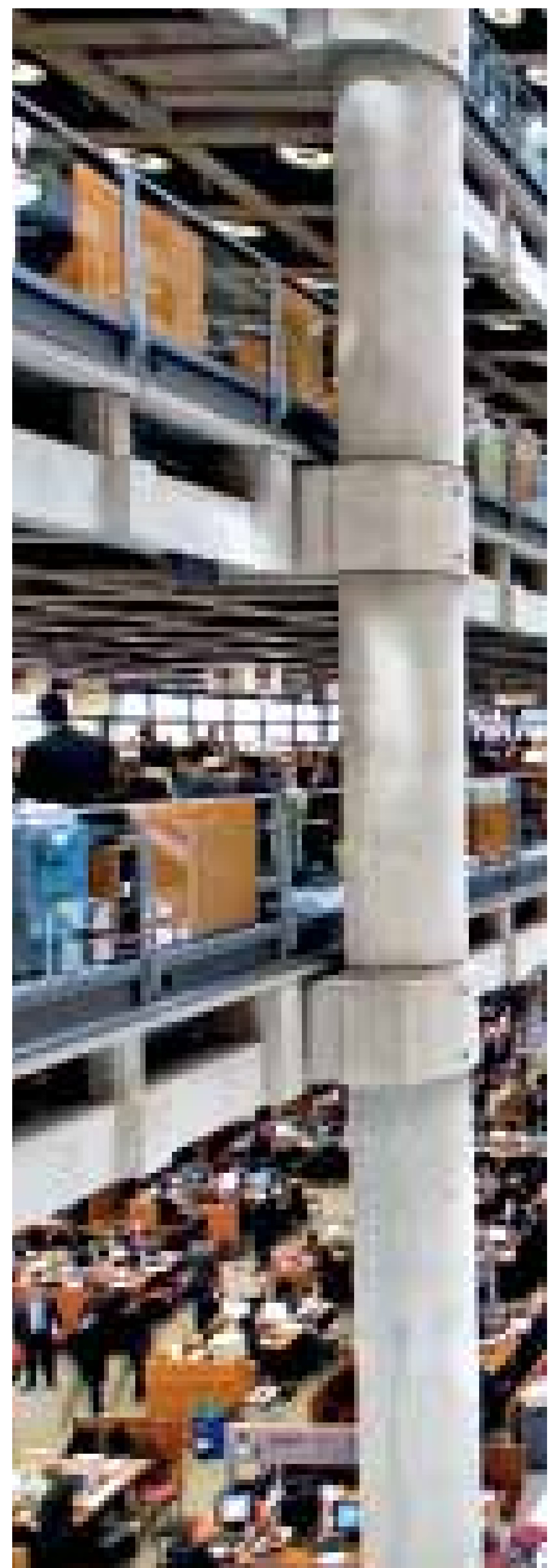
Part of the problem is the sheer size of commercial property debt. Drawing on a survey by De Montfort University in May 2011, the PBF says the total value of debt (excluding Commercial Mortgage-Backed Securities and loans in the National Asset Management Agency) held against UK commercial property was £207 billion, of which £28 billion related to development finance. Compared to this, the value of new loans originated against all UK commercial property in 2010, both investment and development, was £20 billion.

So developers are forced to look for alternative sources of finance. Companies with stronger balance sheets are leveraging up by accessing capital markets, while others are using equity and internal cash flow.

In a significant move, developers are entering into joint ventures with companies that have access to finance. Oxford Properties, for example, is backing British Land at The Leadenhall Building (often called the Cheese Grater), while Canary Wharf, with its access to Far and Middle Eastern capital, is backing Land Securities at 20 Fenchurch Street.

Developers are also using forward funding from insurance companies and pension funds. Aviva is backing Exemplar at →

Words: Lawrie Holmes



Fitzroy Place and Axa currently has a couple of City schemes underway. "There will always be a limited number of leading investment funds and institutions that will finance the right development," says John Rigg of Savills Central London Markets. "Particularly if the risks can be managed out or materially reduced for the investor."

In comparison with the boom times when debt was cheap, an institution's profit share requirements will be seen as expensive. But compared with the cost of loan finance today, institutional cash is quite cheap.

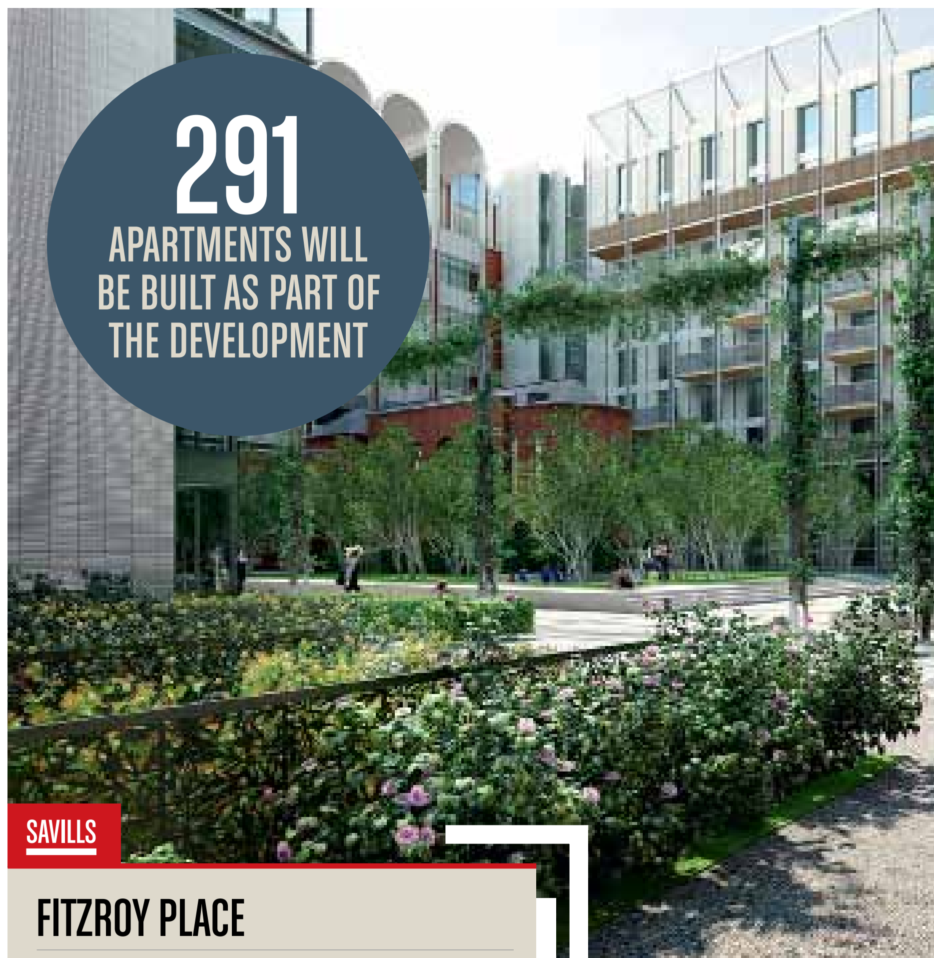
"With a careful transaction structure there is the prospect that the institution can achieve rental growth and better yields than for standing investments," explains Rigg.

COMPARED WITH THE COST OF LOAN FINANCE, INSTITUTIONAL CASH IS QUITE CHEAP

Development finance for institutions is about managing risk. Inevitably, this means developers have to see institutions more as joint venture partners. But that can also be an advantage as having a big name backer gives credibility to a developer in their negotiations with contractors and tenants.

Other overseas funds are also looking towards development. "At a point in the cycle where there has been so little building and the supply picture looks very tight, you would actually expect to find institutional investors taking a view about developing into an improving market," says James Goldsmith of Savills Central London Markets. "That includes overseas funds that have equity ready to expose to London. Indeed, we're working on a number of such potential transactions now."

The chances are that we will see more household names in the future, both from the UK and overseas, backing some of London's major development projects. ❖



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APARTMENTS WILL BE BUILT AS PART OF THE DEVELOPMENT

SAVILLS

FITZROY PLACE

Simon Stone of Savills Central Markets

≥ Savills acted for Exemplar and Aviva, acquiring a 50% interest in the site of the former Middlesex Hospital in central London. Kaupthing, which owned the site, agreed to enter into a partnership to revise the planning and develop the scheme. We continue to advise on the residential and office values and marketing. This substantial project is a very good example of how innovative financing can be secured, putting together a respected London developer, a bank with a failed loan on the property, and a major UK institution. The development will create two office buildings which will provide 221,000 sq ft, 20,000 sq ft of retail and restaurants, and 291 apartments set around an attractive landscaped garden.

FOLLOW THE MONEY

Overseas investors are looking for security in London's commercial property market

While capital for development funding remains scarce, the funds available from large overseas investors for standing investments are substantial. Institutions are competing to secure commercial property in Central London.

"We continue to see an increasing trend towards cross-border investment by large investors in commercial property," says Simon Mallinson, European research director at Invesco Real Estate. "This diversification helps to smooth volatility."

Global investors are increasingly targeting London. "Investors, including pension funds and sovereign wealth funds, are more likely to be buyers of commercial property in London," explains Jon Crossfield of Savills Central London Markets. "They see it as a safe haven."

RULES OF ATTRACTION

Tony Key, Professor of Real Estate Economics at the Cass Business School, believes that the UK's transparency and strong legal structure are attracting risk-averse investors.

"A large number of funds, especially those from the Middle East and Asia, are keen to create a global property portfolio that will inevitably include London," says Key. "If you're a property manager in Abu Dhabi and you're spending £1 billion, you've got to have London in your book."

The acquisition of a quarter of Regent Street by Norges Bank Investment Management is typical of a large purchase by an overseas investor. "They want buildings that look safe," explains Professor Key. "They won't acquire assets for £10 million here and there. They want big chunks."

While these investors may appear to have vast amounts to spend, their strategies are likely to remain conservative. Cleo Folkes, research manager at St Martins Property Corporation, the UK-based real estate vehicle of Kuwait, says the company is taking a back seat on speculative assets.

CHANGING GEAR

"St Martins tends to do ungeared transactions and is no longer involved with [highly-leveraged] developments," she explains. "We only gear up if there is a tax advantage in certain countries."

Nevertheless, the expectation is that London will be where the behemoths of global finance continue to invest.

According to Savills Research, London accounts for double its nearest rival (Paris) for collecting overseas investment. For the period 2007 to 2011, total overseas investment into London real estate was over £52.8 billion. In comparison, Paris attracted £23.4 billion of investment in the same period, while Manhattan mustered little over £10.5 billion. Both 2010 and 2011 saw investment into central London of just under £12 billion each year.

With pressure to invest, but a limited supply of new commercial property in the pipeline, the London market is seeing prime capital values reaching pre-recession levels.

SAVILLS

WESTFIELD LONDON

John Rigg of Savills Central London Markets

≥ This was one of the UK's largest property projects. The 44-acre site in west London had been waiting for redevelopment for decades, but a train depot needed relocation to the west of the site. It was just one of nine rail infrastructure projects that had to be undertaken before the scheme could commence, including diverting the Central Line and constructing a new station just serving the centre.

Savills introduced the project to its client, the open-ended German fund Commerz Real, which provided the original developer with the commitment to both invest in and finance the £1.5 billion project. Westfield completed the project. It is fully let and trading extremely well.

"We opened Westfield London four years ago at a pretty hairy time in the global economy" says Michael Gutman, Westfield's CEO. "Today, the centre is full, with a waiting list of retailers, and we've lodged plans for a second phase, mixed-use development."

From financing to the final scheme, everything about Westfield set new standards. It was Commerz Real's largest project of this type and has certainly paid dividends. Westfield is now one of the UK's most successful centres.

Four Savills specialist teams worked on behalf of Commerz Real, the 50% owner, undertaking the development transaction negotiations, retail consultancy, project monitoring and, following completion, asset management.

BY THE NUMBERS WESTFIELD LONDON

1,800,000
The area, in square feet, covered by the Westfield London site, which is approximately the same size as Buckingham Palace and its gardens.

3,361
The number of glass panels used on the atrium roof.

3
The number of new stations that were built, which included nine separate railway projects and the relocation of a night depot.

750
The number of brands shoppers can buy at Westfield.

LLOYDS OF LONDON

Savills advised the German fund Commerz Leasing on its purchase of Lloyds of London, a Grade 1 listed landmark building in the City.

CITY OR WEST END?

In London's key property markets, it takes expert knowledge to maximise the opportunity for investment and minimise risk

CITY. For investors, the key appeal of the City can be summed up in a single phrase – landmark buildings. "Insititutional investors tend to prefer substantial landmark buildings, with good environmental credentials, offering modern office space," says Felix Rabeneck of Savills Central London Markets. "These are far more prevalent in the City market than the West End."

It's much easier for developers to construct new landmark office space in the City. This has led to a diverse and dynamic market which constantly offers investors new opportunities.

"There have always been new buildings under construction," explains Rabeneck. "From the 1980s, the growth of financial services and the supporting professional industries have been accompanied by new developments to accommodate them."

Yields also compare favourably with the West End. While most investors may dream of an asset close to Claridges or The Ritz, the reality is most have yield requirements that mean the West End is beyond their grasp. In prime areas, yields as low as sub 3% for best retail and 4% for best offices are hard for many investors to justify.

But it's not all plain sailing for the City. The steady stream of new buildings has effectively led to the long-term suppression of commercial rents. That's very good news for occupiers, but less welcome for investors. "The City has oscillated between the mid-£40s per sq ft and £70 per sq ft, in line with the economic fortunes of the capital," explains Mat Oakley of Savills Research. "That is nominal rents, taking no account of inflation. In real terms, rents are now significantly discounted."

This trend has been exacerbated by the "Canary Wharf factor", which has seen huge new buildings taking big occupiers out of the City, keeping rents further depressed.

There is a prevalent belief held by investors that in the coming years office supply in the City could be more modest. Experts point to three key factors impacting on the future of the market. Firstly, the number of sites readily available for redevelopment is now far lower because much of the City of London has been built out. Secondly, where there are sites, often the best outcome is to build high. This is an expensive alternative, requiring high rents to be profitable. Finally, bank debt is scarcely available for the safest investments, let alone for risky speculative developments. As a result, there will be less choice for occupiers, which in turn increases pressure on rents.

"This is a key opportunity for the City," says Felix Rabeneck. "Instead of the constant threat of obsolescence and moderate rents – which has been a risk for institutional investors buying into the area up to now – in the next five years and beyond we could see reasonable performance."

Johnny Dunford, global commercial director of the Royal Institution of Chartered Surveyors, believes that the increasing requirement for sustainability will have an impact on longevity, benefiting the City over the West End.

"The West End, as an alternative location, has premises which may simply be too quirky or restrictive for corporate occupiers," says Dunford. "It's harder to make older buildings more sustainable and as a result they may be particularly expensive to manage."

Of course, not every tenant wants a large building, which might make the West End a more suitable choice. "But, for me, the City has the edge," says Dunford. "It's the right location for occupiers and investors looking beyond the recession."

WEST END. The West End has many attractive elements for investors: distinctive offices, prestigious addresses and close proximity to landmarks like Buckingham Palace and Piccadilly Circus. But does this market offer long-term performance?

The West End is not one cohesive market. It is made up of a number of "villages", including Soho, Knightsbridge and Victoria. Each has a distinct occupier base. For example, demand for space in media-friendly Soho may depend on advertising revenue growth.

"This makes the West End very attractive to investors who are wary of depending on the banking sector in today's climate," says Paul Burgess, head of London leasing at British Land. →

While characterised by diversity, these areas do have one thing in common. "A factor across all West End locations is supply constraint," says Burgess. "Planning is restrictive and existing buildings can be expensive to bring up to contemporary standards for occupiers."

The lack of large lots for new development means most corporate occupiers have to accept existing premises, sacrificing space and a single-site operation for a status address. The West End is also being affected by the conversion of offices into residential.

"For some investors, it's the prestige of the locations that really counts," says Paul Cockburn, West End specialist at Savills Central London Investment. "The scarcity of suitable property is actually what attracts them and, of course, this is the same factor which puts a premium on rents. Our view is that while there is an international focus on London as the world financial capital, attracting international occupiers from every corner of the planet, and while there is supply constraint, rents will continue to grow."

Figures suggest a strong market buoyed by a relative shortage of supply, especially of Grade A accommodation. Prime West End rents in 2011 were £107.50 per sq ft and are forecast to rise to £125 per sq ft by late 2015.

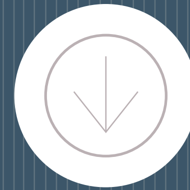
But strong rental income is inevitably accompanied by higher running charges. According to Savills, the average cost of workspace per employee is £13,342, which is 40% higher than in the City.

INVESTORS CAN SEE THE POTENTIAL FOR CAPITAL GROWTH DRIVEN BY UPGRADED INFRASTRUCTURE

At the same time, it is generally accepted that the quality of space is lower in the West End. Smaller buildings, often historic with lower quality technical services, mean occupiers can pay a lot more for a lot less. So there are reasons to be cautious.

However, there are more general benefits from being in a central location. Take transport, for example. "The relative ease of access to Heathrow and now the imminent arrival of Crossrail are an important part of the West End's appeal," says Cockburn. "Investors who are looking at the medium to long term can see the potential for capital and rental growth driven by upgraded infrastructure."

Local knowledge is crucial as the heterogeneous nature of the West End market will see some pockets outperform others. While the supply-constrained nature of the market and future gain from Crossrail will benefit the broad market, prestige is perhaps the most important motive for both tenants and investors. ❖



ON THE MONEY

Our snapshot of the London commercial market reveals strong investor engagement and potential for future growth

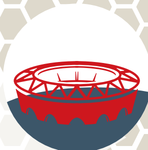
THE WEST END

"CENTRAL LONDON OFFICE AND RETAIL PROPERTY WILL SHOW THE STRONGEST UK GROWTH IN 2012

Savills Commercial

18%
THE AVERAGE RISE IN WEST END PRIME RENTS BETWEEN 2010 AND 2011, DRIVEN BY THE RETURN OF INSURANCE AND FINANCIAL SERVICES TO THE AREA'S CORE SUBMARKETS

OLYMPIC VILLAGE



£10 BILLION
THE AMOUNT THE QATARI SOVEREIGN WEALTH FUND IS INVESTING IN LONDON'S REDEVELOPMENT. PROJECTS INCLUDE THE OLYMPIC VILLAGE AND THE SHARD

THE SHARD

22%
THE AMOUNT OF LONDON COMMERCIAL PROPERTY PURCHASED BY MAINLAND EUROPEAN INVESTORS LAST YEAR

6.4%
THE VACANCY RATE OF OFFICE SPACE IN CENTRAL LONDON. THE RATE CONTINUES TO FALL DUE TO A SHORTAGE OF AVAILABILITY

40%
THE PERCENTAGE OF WEST END PROPERTY PURCHASES BY BRITISH INVESTORS IN 2011

50%
THE PROPORTION OF UK PROPERTY WHICH PROVIDES RETURNS TO UK PENSION FUNDS AND PERSONAL SAVINGS SCHEMES

Compiled by Laura Latham Sources: Savills, London Loves Business, British Property Federation

PROPERTY PITFALLS

James Goldsmith of Savills Central London Markets on making the right investment decisions

For many years, London has been the main focus for international investors, topping the tables as the location of choice. The market is substantial, transparent, liquid and, crucially, easy to trade. This year's Development Securities' report Who Owns The City shows that, for the first time, over 50% of the City of London's investment stock is held outside British hands.

Strong international demand continues in 2012, with many key deals closed by overseas investors so far this year.

The result has been higher prices and lower yields, seemingly unthinkable in the dark days of 2008/2009. There is clearly a recognition of the safe haven London real estate offers, being a byword for capital preservation and a hedge against currency movements.

But just buying investments in London is not enough to guarantee success. In fact, with the capital being one of the world's most cyclical markets, investing in London can turn out to be loss-making for the inexperienced, ill-advised or untimely.

Rental cycles can be volatile, especially in the City of London where prime rents have moved from £40 per sq ft to £75 per sq ft in the core markets and then back again several times. Rent-frees, negotiated by ingoing tenants, are long. So to achieve long leases on letting and re-letting, landlords have to be happy with long periods without income and even the burden of local taxes on empty property. Lastly, rental increases at rent review are a specialist area where uplifts can be notoriously difficult to achieve.

James Goldsmith of Savills

SAVILLS

WHITEFRIARS
Savills advised Union Investment Real Estate on the successful lease re-gear and sale of this nine-storey office building.

There has also been a consistent supply of new buildings, again especially in the City of London. This has had two effects. Firstly, rents have been kept in check because a ready supply of brand new space means there is always "better" accommodation for tenants to lease. Secondly, depreciation can be a serious issue where even a 10-year-old building can look dated and older buildings are seen to be seriously out of date with refurbishment costs sometimes close to the cost of new build.

So acquiring an average building with a medium term income profile, which might look attractive based on running returns, can prove investment folly. At the end of the lease, if the tenant leaves, the landlord can face capital expenditure, long rent-frees and ultimately rents at Grade B not Grade A levels, which in turn means significant valuation problems. Real estate brokers won't touch on these issues when transacting, but property advisors will.

The key for investors is a sensible rental profile, from which growth can be achievable, quality assets in the right location and a flexible specification that can be upgraded and modernised both cheaply and efficiently. Today, more than ever, stock selection and measured advice on market values and the costs of refurbishment are the keys to successful investment. ❖