Office market commentary in

Kensington and Chelsea

frost meadowcroft

Office market commentary in Kensington & Chelsea in relation to the proposed changes to permitted development rights February 2013

For the Royal Borough of Kensington and Chelsea

Prepared by Frost Meadowcroft, Property Consultants

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1. Introduction

The Government proposes to amend permitted development rights to allow conversion of office buildings with a business use class of B1a to residential dwellings (C3) without the need for formal planning permission. The new right is due to come into force in Spring 2013, and will be in place for a temporary period of three years. Exemptions for specific locations may be allowed, but only where the Local Authority can demonstrate that the proposed permitted development rights would have substantial adverse economic consequences.

Frost Meadowcroft, specialist commercial property advisors and agents, have been commissioned to provide information on the office property market in Kensington & Chelsea working in conjunction with Trends Business Research Ltd, economic research & business intelligence specialists. The research from both sources will be used to assess the likely impact of the proposed planning changes for the Royal Borough of Kensington & Chelsea in their application for an exemption.

2. Office Market Commentary in the Royal Borough of Kensington & Chelsea

Summary overview

- An office market that is home to the international music industry and over 400 related businesses.
- High proportion of fashion and design businesses
- High levels of tenant demand – current supply levels unable to meet tenant requirements
- Low vacancy levels compared with neighbouring boroughs
- Increasing rental values since 2010 in response to demand
- Loss of B1a stock to residential will reduce new employment, erode existing hubs and lead to an occupier exodus.

The office market in RBKC falls between the central London and west London markets. These markets are inextricably linked with the ebb and flow of tenants across the boundaries and therefore the general central London trends are reflected in the local market. In addition to these factors, the local market does have distinguishing characteristics and a defined occupier profile as set out below. These clusters create an attraction for similar businesses.

The central London office market

In order to put the local market in context the overall status and trend of the central London office market should considered. Latest research from Knight Frank and Jones Lang LaSalle all show the level of office stock being well below medium term trend levels, whilst demand has also been at a lower level, the end of 2012 saw a positive increase.

- Availability levels in the West End office market are 25% below 10 year average trends
- Current West End vacancy rate is 5.4%. [1] (City 14.3%, Midtown 7.4%)
- Office take up in the West End saw an increase in the last quarter of 2012.
- The West End had 5.9m sq ft of active and potential demand at the end of 2012 [2]
- Take up in 2012 was 2.4m sq ft / 223,000 sq m[1]

The insurance, technology, media & telecoms (TMT) sectors have been particularly active. TMT was the most active sector accounting for almost 30% of all take-up across Central London in 2012. This is also the most active sector in RBKC.

[1] EG London Office Market Analysis 2012

[2] JLL Research West End Office Market Q4 2012

The local market in RBKC

Local areas in the borough can be identified with specific features of demand and tenant profile. As with all markets, RBKC provides a mix of stock from small mews style office buildings scattered across the borough to larger purpose built office developments in the core commercial clusters. RBKC has a full cross section of business types, and as the City of London is known for its financial services, so RBKC is known for its music, fashion and creative businesses.

Whilst many outer London boroughs may be currently experiencing high vacancy levels of redundant office space, the reverse is true in RBKC where vacancy levels are even below the West End market and demand is consistently strong.

Key features of the RBKC office market:

- *Very low vacancy rate of 3.6% (33% lower than the West End, 75% lower than the City)*
- *Current availability of 15,989 sq m (172,042 sq ft)*[3] *significantly less than annual take up*
- *Total stock in borough 442,025 sq m (4,756,189 sq ft) across a total of 2,208 premises*
- *Strong tenant demand demonstrated from recent transactions and active requirements*

Office take up in RBKC

2010 -	129 deals	334,600 sq ft
2011 -	127 deals	333,600 sq ft
2012 -	95 deals	198,864 sq ft

The reduction in the number of transactions in 2012 correlates to the reduced availability of larger sized office floors and lower office supply levels. With the known demand, this suggests that if there had been a larger supply of space available, demand would have been accommodated and this would result in a higher level of transactions.

Availability

The trend over the last 3 years has been reduced availability in the borough and a corresponding reduced take up in the last 3 years.

- Available offices as of February 2013 total 228,591 sq ft (21,244 sq m)
- Annual take-up of around 26,860 sq m (289,021 sq ft) based on the last 3 years average
- Only 9 ½ months of office supply based on the above figures.

[3] CoStar Focus; VOA

The loss of further office stock is likely to restrict local employment, and inhibit the movement and expansion of existing occupiers, potentially forcing them to consider other boroughs in which to locate their businesses.

Office demand and growth

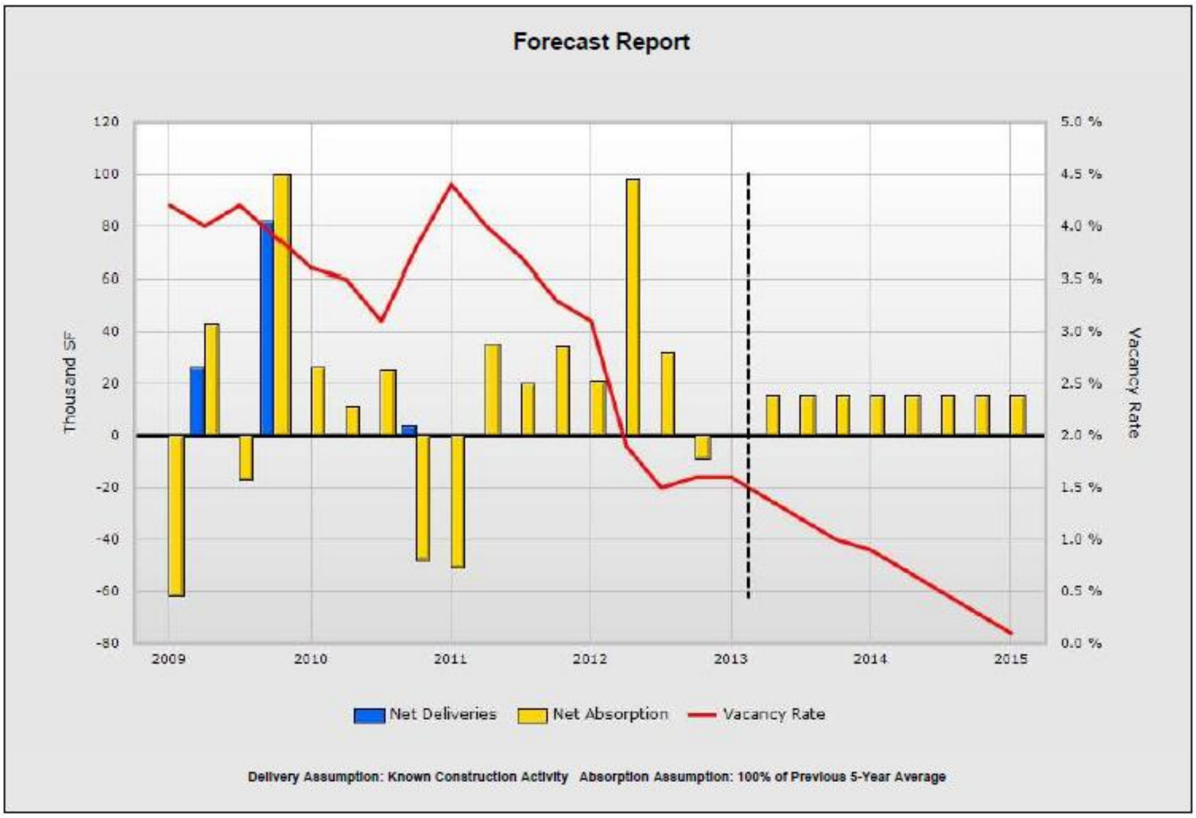
There is viable demand for additional space in the borough's prime office locations, (especially Kensington High Street), and for buildings that offer the character of space available as in the Notting Dale office hub.

There is very little or no capacity to meet that demand in those parts of Kensington & Chelsea which are currently most attractive and popular with occupiers.

In the GLA's trend-based employment projections, between 2011 and 2031 Kensington & Chelsea are anticipated to gain 18,000 employee jobs – equal to 16% in total and 900 net new jobs per year.

This makes Kensington & Chelsea the sixth fastest-growing borough in London.

The forecast for available office space in Kensington & Chelsea based on current take up and availability shows a trend of declining stock levels unable to meet demand. The table below provided by data from the CoStar Group illustrates this trend, the red line indicating negative or positive take-up.



Demand for offices in Kensington & Chelsea is strong and proven with recent transactions in 2012 such as:

Stella McCartney	12,200 sq ft	/ 1,134 sq m	Olaf Street W11
Handlesbanken	2,250 sq ft	/ 209 sq m	Kensington High Street W8
EA GAMES	10,700 sq ft	/ 995 sq m	Sloane Avenue SW3
Quest Management	4,300 sq ft	/ 400 sq m	Golborne Rd W11
Made.com	8,000 sq ft	/ 743 sq m	Notting Hill Gate W8
Mind Gym	7,560 sq ft	/ 703 sq m	Kensington High Street W8
Egmont Publishing	6,400 sq ft	/ 595 sq m	Nicholas Rd W11
Virgin Music	5,940 sq ft	/ 552 sq m	Nicholas Rd W11

In 2012 commercial agent circulated requirements for the West End and west London totalled approximately 10 million sq ft (930,000 sq m)[4] demonstrating strong potential tenant demand.

Further recent research shows office demand in Kensington & Chelsea between 2011-31 is estimated at around 27,000 sq ft (2,500 sq m) of additional space per year. The planning and development pipeline for offices is just 215,000 sq ft (20,000 sq m). To meet the tentatively estimated demand over a 20-year plan period, the Council in due course would have to identify sites for an additional 320,000 sq ft (30,000 sq m) of additional office space.[5]

[4] West End Office Agents Society
[5] RBKC Commercial Property Study 2013, Peter Brett Associates LLP

3. The main office hubs

Hub **Notting Dale W11**
Profile **Fashion and Media (TMT)**

Features

Located in the Freston and Bramley Road area just to the north of Holland Park, bounding the West Cross Route, this area sits on the western most boundary of the borough. This hub features some of the larger and newer office buildings in the area and home to some notable companies in the Fashion & Design sectors (Stella McCartney, Monsoon Accessorize, Louise Blouin Foundation, Donna Ida Jeans, Cath Kidston, Col Art Group, Charlotte Olympia Shoes, Mario Testino photography, Egmont Publishing).

The larger floor plates and higher specification offices available in this location have attracted larger companies such as Monsoon Accessorize, Talk Talk, Stella McCartney and Cath Kidston.

Public transport is good with close proximity to the underground station at Latimer Road and also within easy walking distance of Westfield London shopping centre and Shepherds Bush underground and overground stations. The area is within the Freston & Latimer Road Employment Zone and also close to all the amenities of Notting Hill and Holland Park and the associated high residential values.

Hub **Golborne**
Profile **Small Creative & Design**

Features

This hub is characterised by buildings let on short term leases to very small and start-up companies notably in the creative industries and design. There is also a greater prevalence of the lighter industrial style business, attracted by the lower rental values and the availability of more studio style workspace. Buildings include Camelot Studios, Pall Mall Depository, Grand Union Centre and Westbourne Studios.

This hub is further from public transport facilities in this area and is therefore less accessible being a 15 minute walk from Ladbroke Grove and Westbourne Park stations. This is a further feature that will inhibit larger occupiers and higher rental values.

These areas provide a valuable incubation accommodation for small businesses that grow and then relocated to better hubs in the borough. The Phoenix Brewery building in the Latimer hub has been a recipient of several of these growing tenants.

Residential values are approximately half of those in the more prime areas of the borough.

Hub **Kensington High Street**
Profile **Music Industry**

Features

The office market around Kensington High Street has become the centre of the UK's music industry with all the 3 major international are labels located in this hub. (See separate report)

Other occupiers include larger corporates, PR, marketing, travel industries and financial. (Mark Warner, Trailfinders, Associated Newspapers, Mind Gym, The White Company).

99 Kensington High Street offers the largest floor plates in the borough. Other more recent developments such as 5 Young Street and 37 Kensington High Street provide Grade A offices with rents ranging from £45 - £50 per sq ft.

Very good transport facilities and local amenities make this a sought after location and a realistic option to many companies considering the traditional West End market. Many company directors either live locally or in west London due to the quality of residential accommodation and choose not to commute to central London to avoid the congestion of central London.

The surrounding areas are also the borough's highest residential values.

Hub **Knightsbridge and Chelsea**
Profile **Marketing & PR, financial, High end fashion and retail companies**

Features

The proximity of this hub to the West End makes Knightsbridge an extension to the Mayfair and St James' office markets. All sectors of property in this area are generally at the top of the capital value range.
There are good transport facilities throughout the area and the predomination of high class retailing encourages the associated offices of these retailers to be located close by. Notable occupiers include Tommy Hilfiger, Moncler, Manolo Blahnik and Joseph. Prime rents in this hub exceed £60 per sq ft.

The sub 1,000 sq ft market

An important feature of the RBKC market is the small office market occupying properties such as former light industrial, stables, garages, coach houses, and mews around the borough amongst the existing residential stock. There is more of a prevalence of this type closer to the hubs and they create a diversity of occupier in these areas which is valued by local occupiers and sought after by owner occupiers and tenants.

Examples of these offices include (but not exclusive to), Drayson Mews, Ledbury Mews North, Radleigh Mews, Astwood Mews, Adam & Eve Mews and Hornton Place.

4. Residual Values – the value disparity

- RBKC residential property values are some of the highest in UK.
- The financial incentive to convert office space to residential across RBKC will be substantial.
- Office values will see an increase of over 100% in residual values if residential is permitted.

With the exception of the Golborne office hub, the remaining office hubs in RBKC are within or adjacent to prime residential areas. The borough has one of the highest residential values in London, ranging from £750 - £2,500 per sq ft. Existing office values range between £350 - £750 per sq ft.

Taking into account the usual development costs associated with residential developments, we have calculated that residential values would only need to be 40-55% greater than existing office values to make a compelling financial case for residential conversion.

We have identified only a small percentage of existing office stock that would be unviable for conversion to residential based upon cost such as floor plate sizes or other practical restrictions.

In most cases, even assuming for higher costs for difficult conversions, there are still viable profit levels to convert to residential.

Residential Property values Source: Zoopla				
Area	**Postcode**	**Flats**	**All properties**	**Average - All properties**
RBKC	W8	£1,415,987	£2,202,433	**£1,456,449**
	W10	£445,018	£589,195	
	W11	£811,990	£1,434,154	
	SW3	£1,058,222	£1,774,059	
	SW5	£924,638	£1,042,364	
	SW7	£1,529,836	£1,872,917	
	SW10	£886,318	£1,280,020	
Westminster	W1	£1,106,099	£1,228,167	£1,213,618
	SW1	£967,069	£1,199,069	
Ealing	W5	£346,087	£547,763	£547,763
Wandsworth	SW18	£411,545	£590,799	£590,799
Camden	NW1	£551,534	£679,250	£679,250

The table above illustrates the very high residential values in RBKC compared to other London boroughs. The potential profits to be gained (see the summary of residual valuation examples below) will put extreme financial pressure on investors and property owners to obtain vacant possession of the buildings in order to convert within the initial 3 year period. With the substantial level of profits available, landlords will be in a position to offer significant payments to induce tenants to surrender longer term leases earlier than the lease expiry date. With the already limited office stock in the borough, it is inevitable that these companies will be forced to move further afield to other areas in order to find suitable relocation.

Summary of example case study residual valuations

	Existing Value (£)	Residual Value for Residential Conversion (£)	Percentage increase	Office value (£ psf)	Breakeven point (£ psf)	% difference
Building 1- Freston & Latimer Road Employment Zone, W10	£12,010,000	£25,250,000	110%	£396	£565	56.65%
Building 2 - Kensington High Street, W14	£36,290,000	£76,070,000	110%	£542	£688	55.00%
Building 3 – Kensington Church Street Square, W8	£49,000,000	£94,360,000	93%	£864	£989	56.70%
Building 4, Kings Road vicinity, SW3	£11,320,000	£32,260,000	185%	£584	£963	41.50%

Note to table: A basic residual valuation has been undertaken on the sample buildings above assumed to be capable of conversion to residential without redevelopment.

The borough's main office clusters as identified, with the exception of the Golborne Hub (W10 area in the residential values table above) are situated in the UK's highest residential value areas. This creates greater financial incentive for conversion to residential. As a result of these very high residential values, developers are creating what has become known as the Super Prime Residential Market. This has been dominated by overseas purchasers and investors taking advantage of the weak GB Pound and speculating on further inflation in this sector of the market.

An example of this is Charles House, 375 Kensington High Street formerly a large 1970s office development which is currently being developed by Berkeley Group. 60-70% of the total sales to date have been to overseas investors off plan. This sales pattern is in line with research from the largest central London residential agencies on the level of overseas purchasers.

It is clear that the type of residential stock that would be converted in RBKC as a result of the proposed changes would fall in to the "prime" category. These new dwellings will not provide the type of lower value and affordable housing required by the local authority or in the desired locations that would normally be provided under existing planning requirements in the case of new developments.