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Property Occupation Costs – "The Perfect Storm"

A "perfect storm" in Central London and the South East is brewing. Increasing costs in rent, rates, services and salaries are all kicking in and for some businesses, their profits will be severely eroded. But is there anything you can do? Whilst the increases are inevitable are there ways to manage the impact?

Why are Costs Increasing?

Increased Demand

Improvement in the economy has meant that 2014 is set to be a strong year in terms of leasing activity. Units under offer are at near unprecedented high levels and active demand continues to strengthen. Central London take-up for Q1 2014 totalled 2.7 million sq ft which was 18.3% up on the previous quarter, 19% up on both the previous quarter and the five yearly quarterly average.

Restricted Supply

Currently, there is insufficient volume of new construction to meet demand. Office completion levels averaged 2.9 million sq ft annually between 2010 and 2013, with only 1.7 million sq ft having been completed in 2011. This compares with the 30 year average of 4.4 million sq ft. There is 6.9 million sq ft scheduled for 2014 – the most since 2003. However, the supply impact will be limited as 40% of all new space completing this year has already been let. Developers are already starting to respond, but the typically long lead in times between development starts and completions means that it will be at least three years before any meaningful amounts of new space are introduced.

Increased Rental Values

The combination of increased demand and limited supply has led to increases in rents. Prime West End office rents have risen between 10.5% and 13.6% since Q2 2013 and London's West End has remained the world's highest priced office market. Central London office rents are likely to end 2014 5% to 9% higher than at the beginning of the year.

The increases are not limited to prime locations in the City and West End. All parts of the London office market are witnessing increases in rents and declining rent free periods. There are now just four London office sub markets capable of offering refurbished, air conditioned office space at rents below £35psf – these include Stratford, Docklands, east City Fringe and West London. However, rents in these locations are under significant upward pressure.

A similar picture is also being witnessed outside of Central London in virtually every major commercial centre.

Change in the "Balance of Power"

Lower vacancy levels and strengthening demand for office space is causing a shift in the balance of negotiating power away from tenants resulting in:

- Lower levels of rent discount on the landlords' quoting rent
- Shorter rent free periods
- A reluctance by some landlords to accept tenant only lease break options
- Larger rent deposits where the financial status of the proposed tenant is considered weak
- Lease clauses tending to favour the landlord

Business Rates (Property Tax)

Over recent years, above target inflation has caused the uniform business rate (UBR) multiplier to increase at a fast rate, as it rises each year in line with RPI inflation. This is coupled with the fact that current rateable values are linked to rents set in 2008 – the peak of the market. The usual 5 yearly pattern for revaluation might have provided some respite with lower rents in 2013. However, the government decided to defer the next revaluation by two years with a valuation date of April 2015. Rents are set to continue to rise until that date and therefore the increase in rate liabilities is also set to continue. The classic double whammy.

Energy Costs

According to the Federation of Small Businesses, UK energy bills for businesses are set to increase, due to a new government policy to help tackle climate change. Businesses have seen their bills increase by 21% in the wake of these changes, and this figure is set to rise even further; up to 22% by 2020.

Employee Costs

After nearly six years of falling real wages, rises in weekly earnings have finally caught up with inflation. Weekly wages, including bonuses, rose by 1.7% in the year to February, up from 1.4% in January, according to the Office for National Statistics (ONS). Mark Carney has told the UK trade unions that wages should start rising in real terms "around the middle of next year" and "accelerate" afterwards. To compound matters, the extraordinary rises in the cost of residential accommodation has meant employees have less in their pockets. The result? The best will either cost more to keep or they will move to your competitors for more money!

Warning - Changes in Legislation

New Energy Performance Certificates (EPC's) are due to come in to force in April 2018. The changes will mean that it will become unlawful for any commercial property to be either sold or let where it has an EPC rating of below band E. This will have significant implications for dilapidations liabilities and the ability to dispose of surplus space.

What should you do about it?

For many organisations Total Occupancy Costs (TOC) it is the second highest P&L line item and the biggest contingent liability. It should be under constant scrutiny to ensure expenditure is understood and managed. Many businesses do keep a close eye but over recent years we have been surprised at how many still:

- Occupy too much space
- Do not really understand how to manage a rent review or lease renewal
- Leave themselves too little time to affect and manage change
- Spend more than they need on their fit outs
- Place too much emphasis on the cost of expert advice as opposed to the value it can deliver
- Do not forecast or truly manage their property risks

During the recent years of greater competition, tougher margins and tight funding, Avison Young has encouraged all occupiers to assess and manage their TOC, proactively manage their premises burden and update their accommodation strategies. We adopt our THINK>PLAN>DO methodology in helping clients with this and to look at the true business need, the business imperatives and then to constructively challenge the status quo.

In light of the current market conditions of increased demand for space, restricted supply and higher rental values, a timely, constructive approach is even more important.

For further information:

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