EXPERT OPINION

Regional offices - risk or opportunity?

Lender Leumi explains why it is keen on the regions

Leumi refinanced Birmingham's The Mailbox. (CoStar)

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It is sometimes assumed that the London office market should be viewed entirely differently to that of the rest of the country, that it is home to businesses of a completely different scale and nature to those of the big six regional markets (Glasgow, Leeds, Edinburgh, Manchester, Birmingham, and Bristol).

As always, the reality is more nuanced, and in many cases it is fair to say that the trends that have been sweeping through the London market in the years since Covid are now starting to permeate across other parts of the country.

First of all, there has been a clear flight to quality in the UK's capital. According to Cushman & Wakefield, Grade A offices accounted for 77% of leasing activity in Q2 2024, the highest quarterly share on record. We're seeing the same pattern in the regions - Savills reported that Grade A take-up in Birmingham accounted for 74% of the total in Q2, and 70% in Manchester.

In fact, there is a universal shift towards high quality urban locations, with take up in the first half in the Big Six regional markets up 10% year-on-year. On the back of this, rents in these markets are expected to grow by 9% in 2024.

The primary factor driving this trend has been the changing requirements of occupiers and their employees. With the shift to working from home, large corporates are more aware than ever before of the need to attract staff to their offices. That means not only ensuring an office is easily accessible with strong transport links, it also means curating a space that is attractive and engaging.

Collaboration is increasingly a priority, so along with catering for the peak 'in-office' day for staff, companies want more meeting spaces, attractive break-out areas, and additional amenities. What we're seeing is that rather than needing 40% less space because employees are only coming in to the office three days a week, businesses actually require the same if not more space than they did pre-pandemic. As a result, office tenants in London have become increasingly demanding and sophisticated when it comes to fit-out.

While companies outside London are facing the same pressures, developers in the regional markets struggle to build new Grade A stock due to high construction costs and lower rents. As a result, there is a significant supply/demand imbalance in the Big Six regional markets. To put it into perspective, the viability threshold for Grade A offices is £50 per square feet in rent and as none of the regional markets trade above this threshold, there is unlikely to be supply side pressure in the medium term. On top of that, new flexibilities in the permitted development rights regime came into effect in March of this year and make it even easier to convert commercial buildings like offices into residential.

Another important factor behind the flight to quality in London has been the introduction of carbon reporting requirements, which means that companies over a certain size have to publicly report on their UK energy use and carbon emissions. Alongside that, it is anticipated that commercial rented properties in England and Wales will be required to have a minimum EPC rating of C by 2027.

According to Cushman & Wakefield, most offices in the capital will fail to meet the minimum standard for leasing within the next four years. However, while some large corporates in London will now only consider moving to an energy efficient property, environmental credentials have been less of a priority outside the capital until far more recently.

There are a number of reasons why we at Leumi UK are actively looking at new opportunities in the regional office market. First and foremost, the imbalance between prime rents and build costs is so significant that new office developments are off the cards unless tenants are willing to pay market busting rents. This has led to a shortage of top-quality stock, and on top of that values have fallen over the last 24 months.

As a result, there is a clear opportunity to lend, but only if you're prepared to be selective, discerning, and flexible, and take the time to find top tier sponsors with the right asset and a robust business plan. It is a sector where adopting a counter cyclical approach, acting quickly, and being prepared to offer bespoke terms is the name of the game.

There are a number of factors that we as lenders take into consideration when assessing a potential regional office project. First and foremost, does the asset have strong fundamentals? By that we mean proximity to a major urban centre, good transport links, and thriving local businesses wanting to occupy good quality space. And then almost as important is the connection with the sponsor. Is there an existing, trusted relationship and/or do they have a track record of delivery as well as a credible business plan? Alongside that, there is clearly the question of value.

We have found a number of opportunities that meet this criteria - strong fundamentals, top tier sponsor, and sound business plan - over the past twelve months. For example, in August Leumi UK provided £65 million to Martley Capital Group to support the recapitalisation and refinancing of The Mailbox, an iconic building in Birmingham city centre which is one of the UK's largest mixed-use developments outside of London.

Similarly, in May Leumi UK and alternative asset manager Westbrooke agreed a £33 million refinancing package for Fort Dunlop, a mixed-use asset in Birmingham owned by EPIS03 and advised by pan-European real estate investment manager Tristan Capital Partners.

On the other side of the equation, it is clear that there remains significant occupational demand. For example, Forma Real Estate Fund recently announced that it has secured another prelet for its Aurora Glasgow office development project, where it is undertaking extensive refurbishment work to create a grade A sustainable workplace.

Ultimately, we believe that, across all sectors, the most compelling deals are found when you are adaptable and responsive to the changing dynamics of the broader environment. There are always opportunities to be found, but only if you are prepared to work that bit harder on your due diligence.

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