Bradley-Mason LLP

Office Markets – Leeds and Manchester

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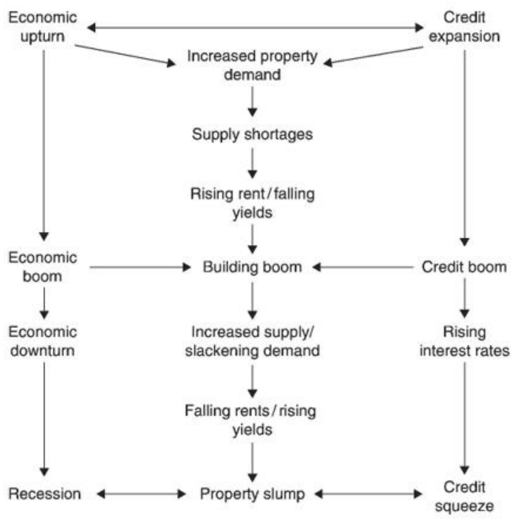
This report looks into the office markets of two Northern UK cities. A variety of industry sources have been examined and will be explained throughout.

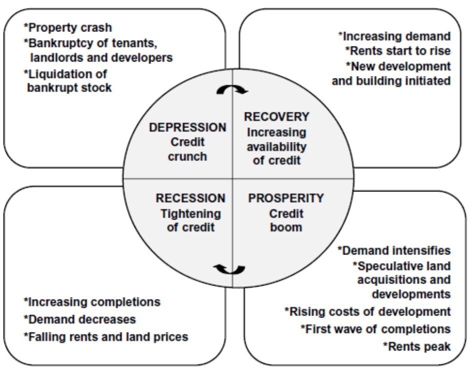
The building cycle is made up of a combination of factors from the business cycle, credit cycle and the development cycle of the property market. The model is displayed below and is an illustrative way of understanding the dynamics involved in the creation of the cycle.



The four main property cycles which occurred between 1962 and 2000 were all linked to movements in the economy and were the result of the combination of strong demand growth shortages of supply and credit expansion. When exploring the property cycles of more developed economies, a link can be seen to the business cycle and GDP. GDP fluctuates over time at the level of economic activity, if GDP is high, this is reflected in companies making profits and potentially expanding the business along with employing additional staff. This links to property markets, as when companies grow, they may relocate to bigger or better premises to suit their needs, this is known as 'derived demand'. The cyclical activity of the property market is also linked back to the economy, when new developments are complete this money feeds back into the economy. When GDP peaks, it creates a boom at the top of the cycle, similarly when it dips it can create a slump.

Property cycles are influenced by both exogenous factors and shocks from the macro-economy and endogenous factors from within the property sector. Exogenous factors can include natural disasters or institutional changes. The way the market reacts to these can impact interest rates and government policies, which impact occupier demand and the property market. Endogenous impacts come from within the property industry such as the time lag of development and its inflexibility. These factors work together impacting supply and demand thus creating the cyclical activity.

The link between the economic financial cycle and the property cycle can be observed in the model below. It shows how the four main stages of the financial cycle impact the property cycle, affirming the link between them.



The RICS define a property cycle as 'a logical sequence of recurrent events reflected in factors such as fluctuating prices, vacancies, rentals and demand in the property market'. We will look at some of these factors below.

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In regards to vacancy rates, the overall rate in Manchester is 6.1%, down from 7.7% in 2015. Leeds stands at 4.1%, again showing a decrease from 2015's 4.4%, showing an increase in demand. Grade A office space in both cities is seen to be in high demand with vacancy rates at 1.4% in Manchester and 1.8% in Leeds (JLL H1 2016). From sources it appears Leeds has no new builds set to complete in 2017 and so far, only 115,000sq. ft. due to complete in 2018 which could lead to a potential supply gap, with rents increasing as seen in the recovery phase in the above model. The lack of construction, along with demand increasing, could influence more developers to start building. However, property is inflexible and inelastic, as it takes time for the new supply to reach the market due to factors such as gaining planning consent and delays within the construction industry. It may then be that when these new developments complete there is an oversupply of offices and as a result we could see rents starting to fall.

Although Manchester currently has a high rate of refurbishments in progress, vacancy rates are tight. According to the Deloitte Crane survey, 78.4% of the new builds set to complete in 2016 are already pre-let, highlighting the strong demand. Grade A office space can be more desirable as is newer, with city centre locations and good transport links making demand higher, which is reflected in the higher rents.

Manchester saw no Grade A developments start in H1 2016 and none are set to start in H2, again there could be a supply gap of Grade A space with similar consequences to Leeds. Colliers (2016) predict Manchester could have 'an 'unprecedented' complete absence of 'ready to occupy' Grade A supply by the end of 2016', which they envisage to last well into Q3 2017. The strong demand and shortage of supply for Grade A space in both cities could imply that they sit somewhere between the recovery and prosperity stages of the cycle shown in the above figure.

The city centre take up in both cities is lower than last year. Take up in H1 in Manchester was 416,023 sq. ft. Leeds only saw 195,011 sq. ft., 48% lower than H1 2015 (CBRE 2016). The low take up figures could be related to the limited Grade A space available as this can be more desirable than refurbished properties. Another reason take up could be lower may be due to the uncertainty of the aftermath of the Brexit vote. Companies may delay deals until it is clear what trade deals are established and to what extent they can access to the common market.

The current prime yield in Leeds stands at 5.5% and 5.0% in Manchester, the same as 2015. CBRE states that this could be due to shortage of deals. Cushman & Wakefield predict the prime yields in both cities will not increase over the next few years. This could be due to the uncertainty of the impact Brexit will have on the economy.
The current prime rent in Leeds is £27 (per sq. ft.) and £34 in Manchester. Manchester stood the same in 2015 with Leeds rising slightly from 2015's rate of £26.50. Data on rents in Manchester differ slightly with Colliers (2016) suggesting that the supply shortage could see rents rising as high as £40 per sq. ft. by 2019. However, CBRE predicts that the Manchester rent will remain the same for the rest of 2016 as JLL's Office Property Clock (Q3 2016), suggests the 'rental growth is slowing'. This is interesting as with the demand intensifying and the shortage of Grade A space, one would forecast the rents to keep rising until further development completes as the property cycle suggests. However, one reason for rents not rising may be due to the large amount of refurbished property available to let at competitive rates. If in the future, there was to become a shortage of secondary office space then we could expect rents to rise further.

Market reports show that despite the EU referendum result, there has not been any major signs of slowdown in either of the office markets. However, the majority of respondents to the RICS Q2 Commercial Property Market Survey felt as though the UK is currently in the early stages of a down turn phase. The exogenous influence here is the political uncertainty. We are unsure on the long-term impacts which have seen investors holding off on deals.

On the contrary, Brexit could be seen as an advantage for the both cities' office markets. Companies could save a lot of money if they relocated from London to the North. The difference between London rents and those of Leeds are at the widest gap of the last 20 years, with Manchester currently at the widest it's ever seen (Savills 2016). With plans for HS2 and the Northern Powerhouse, Leeds and Manchester are strong options to relocate to. There is a lot of refurbished property available with advantages such as lower prices, flexible leases, quicker availability and good potential investments with lower risks and good returns (CBRE 2016).

As property cycles differ in lengths and development takes time to complete it is hard to predict exactly when each stage of the cycle will happen. We cannot foresee the exogenous factors and shocks to the economy.

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The data examined showed that both cities have not seen a noticeable difference following the Brexit vote, however, with this only happening a few months ago, we are still waiting to see the changes it will create. Both cities are good locations for businesses with good transport links and the rents compared to London are a lot lower, so advantageous to companies.

With the shortage of Grade A space in both cities, we may see more planning and developments starting which will see rents levelling off. However, with the reasonable supply of refurbished property in both cities, we may see these becoming more popular. With current lower rents and high availability these are a viable option for companies to relocate to. If we do see demand for refurbished property increasing and supply slowing down, we can expect to see the rents rising.

Leeds and Manchester both have a strong office market offering worthy advantages. I do not believe that the vote to leave Europe will have a big impact on their office markets, if anything I predict it will make them stronger and a higher demand for space will be seen in both Grade A and refurbished space over the next 12 months.

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