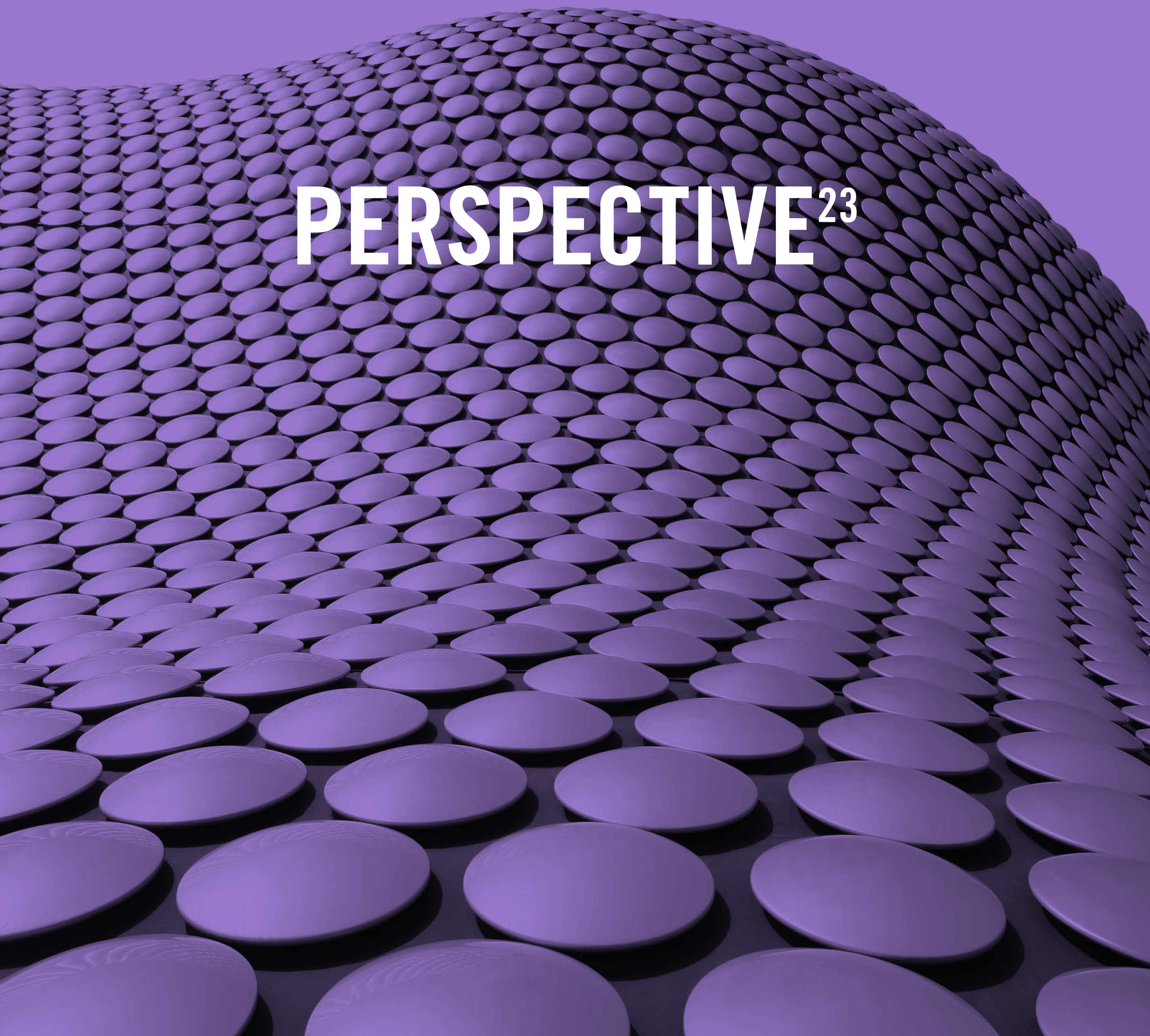
CHANGING LANDSCAPES

THE CHALLENGES OF OBSOLESCENCE
TURNING LIABILITIES INTO ASSETS
EFFECTIVE FUTURE PROOFING

PERSPECTIVE23



TIME AND TIDE WAIT FOR NO MAN

ALAN PEMBERTON

Time and tide wait for no man – so said Geoffrey Chaucer. These words have certainly stood the test of time. And even earlier, Roman poet Vergil coined the phrase "Tempus Fugit", or Time Flees. We cannot really argue with either of these sentiments.

Some buildings definitely age far better than others. On the other hand, even if the facade is well cared for, occupiers will not wish to occupy the property if it is impractical or uneconomical to run.

There is however a distinction between a building that has deteriorated and one that is obsolete.

Deterioration is the physical decline of the building's fabric whereas obsolescence can take many forms due to a change in user requirements (functional obsolescence), a reduction in a buildings competitive usefulness and value (economic obsolescence) or the impact of nearby developments and infrastructure (external obsolescence). It is these elements that will decide what ultimately happens to the property, irrespective of age and location.

Once classed as obsolete, what are your options: refurbishment, alternative use or ultimately demolition? Obviously commercial viability will have a major say which one of these is the preferred option.

Over the past few years we have seen some prime examples of obsolescence driven development throughout the UK. For example, the iconic industrial Fort Dunlop building along the M6 Motorway and the Rotunda office building in Birmingham city centre became obsolete as commercial properties. However, with Urban Splash's entrepreneurial vision, they were extensively refurbished and now enjoy a new lease of life as offices and luxury apartments respectively.

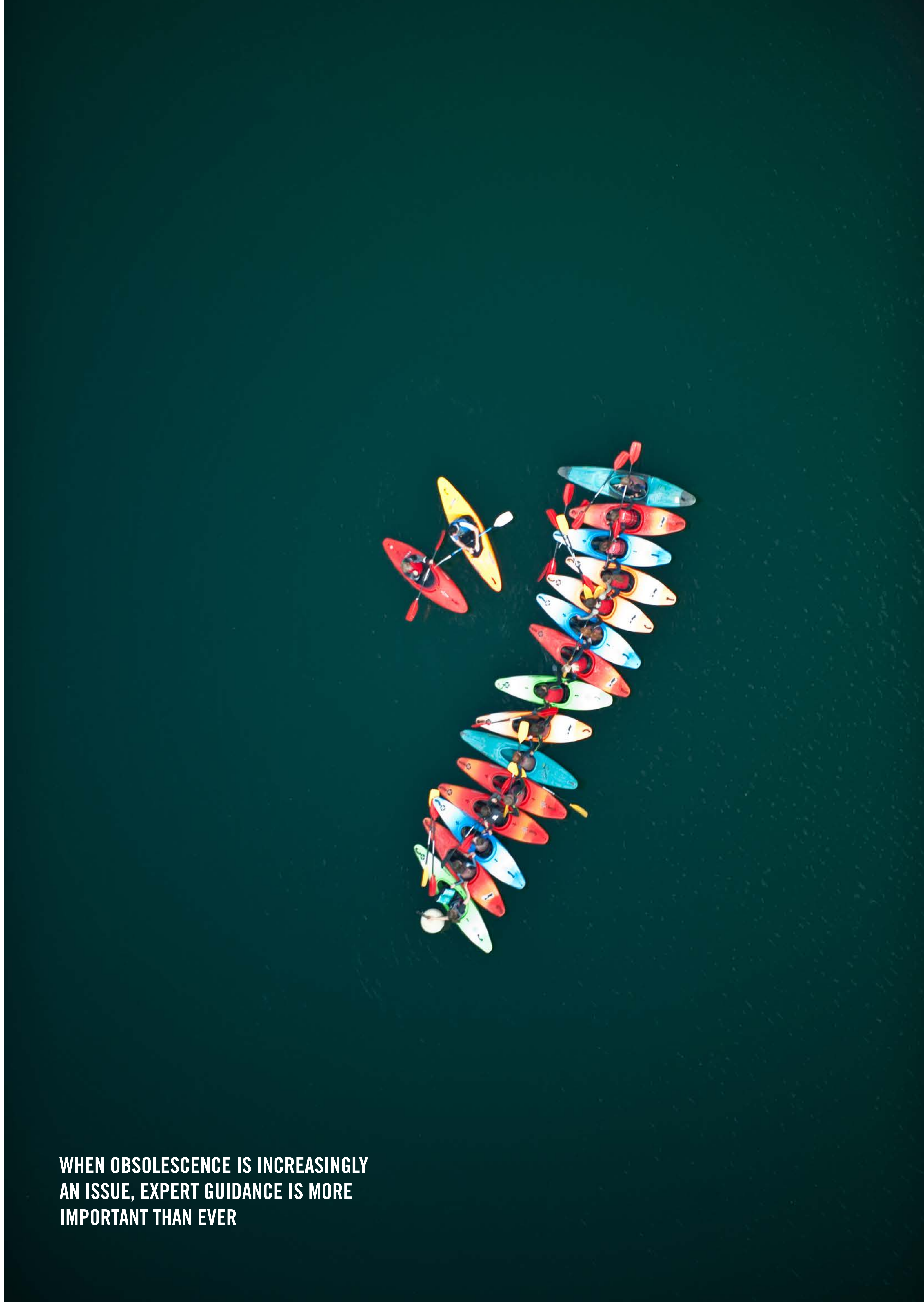
So, that's the immediate past but what about the present and the future?

Obsolescence will increase as ageing stock no longer meets the demands of businesses adapting to new technology and working practices. Accordingly, we are all likely to see more refurbishment to upgrade existing offices and, when allowed by market forces, more conversions to residential use, hotels and student accommodation. This point is picked up by Richard Kauntze, Chief Executive of the British Council for Offices (BCO) in his guest article which appears in this edition of Perspective. We extend our gratitude to Richard and the BCO for their contribution.

Obsolescence has been a driving element of various redevelopment proposals. But what of existing relatively new buildings of vintage 1960's, 70's and even 80's stock? How can these be future proofed? In many cases, fitness for purpose is obsolete rather than the building itself. In addition to being well designed and aesthetically pleasing, new builds and refurbishment will need to incorporate increased flexibility to enable quick and relatively inexpensive revisions to work spaces in order to meet changing occupier requirements. Energy in use, BREEAM ratings of at least 'very good' or above and energy efficiency levels will be high priorities. Floor plate sizes and configuration will need to be adaptable, whilst access to the latest technology is essential.

Obsolescence is difficult to define and even harder to monitor. It is far more subjective than physical deterioration and can vary dependent upon whether you are approaching it from an investor's viewpoint or that of an occupier. However, it is vital, in today's challenging market, to identify the symptoms, make accurate diagnosis and treat the problem before it becomes terminal. This is at the core of the consultancy approach we have adopted for all service lines in avoiding obsolescence: taking time to make an accurate diagnosis, consulting with specialists, reviewing and reflecting on findings. Issues can then be articulated in a concise manner with timely and costed solutions recommending how these can be overcome. Geoffrey Chaucer also wrote "First he wrought, afterward he taught" and this sums up our 'applied learning' approach.

Alan Pemberton
Managing Partner
Tuffin Ferraby Taylor
apemberton@tftconsultants.com



TDD – SUPPORTING YOUR INVESTMENT DECISIONS

DAVID MANN
TECHNICAL DUE DILIGENCE

With slow growth prospects in recent years, low transaction levels (especially outside London) and a lack of good stock returning to market, investors and fund managers are presented with a myriad of factors when assessing the future capital growth, lettability and income potential of a property investment.

The Technical Due Diligence (TDD) process is designed to consider a property in non-destructive forensic detail and provide investors with all the pertinent information not only about its condition but also site related issues, problematic materials, statutory compliance, environmental matters, notes for solicitors and asset management opportunities.

Highly sought after prime assets – typically those on long leaseholds with a strong covenant to provide almost bond like investment security – are in increasingly short supply and competition between those entering the market, particularly new foreign investors, can often lead to a bidding war or off-market deals. This is triggering many investors to consider alternative property investment strategies.

Historically, with buildings let on long leaseholds, landlords had little incentive to invest capital in their property. The return to market of so many buildings from the late 1980s construction boom has found landlords increasingly left with defective and obsolete properties. The functional and physical obsolescence will have a direct correlation to an asset's future lettability and investment value.

This increased supply is further compounded by reduced tenant interest and the emerging trend of shorter leases and more frequent break options to increase business flexibility. As a result, landlords are having to work harder to attract and retain tenants – with enticements such as rent free periods, financial incentives or lease re-structuring becoming the market norm.

For many investors, this shift in market dynamics creates a new focus when appraising a property. They must now consider green leasing, sustainability, life cycles and obsolescence issues, alongside the traditional factors of supply, demand and, of course, location. However, the shift in market conditions also provides investors and landlords with asset management opportunities to refurbish and redevelop such secondary properties to maximise their potential.

Today's more informed TDD process can assist in the evaluation of a property's deficiencies and its potential much earlier. Feasibility studies and further investigations can be run alongside the process to explore, with the acquisition team, the full potential of further opportunities and associated risks.

An example of this was a recent instruction where we led a detailed feasibility study alongside the TDD process to evaluate asset management opportunities. These included replacement of the defunct mechanical and electrical installations, an upgrade of the external cladding and remodelling of the floor space to increase its flexibility in a multi-storey city centre office property. Specialist cladding investigations, concrete testing and drainage surveys were commissioned to help increase cost certainty prior to acquisition. All of this allowed the economic viability of options to be considered and supported justification for 'chipping' the price.

What is clear, however, is that these new territories; of building-in sustainability and designing-out building obsolescence are driven by looming and legislated energy issues such as the Energy Act. They are leading the transformation in the approach to property holdings. TDD is at the forefront of any effective decision-making process.

Our new TDD report format, launched this year, is designed to look wider, deeper and beyond the current state of the building's condition, to anticipate the property's future viability to remain relevant to the property investment and occupational markets. Our TDD processes are here to support your investment decisions.

For more information contact David Mann dmann@tftconsultants.com

David Mann chaired the RICS working party which developed its influential 'Building Surveys and Technical Due Diligence of Commercial Property' Guidance Note

THE ENERGY ACT: CHALLENGE OR BLESSING?

MAT LOWN
SUSTAINABILITY

If Government proposals under the Energy Act come into force, 1 in 5 commercial properties could be un-lettable from 1 April 2018.

The Energy Act 2011 introduced the concept of minimum energy performance standards and Government proposes from April 2018 landlords will be unable to let a property with an energy performance certificate (EPC) rating of less an E. An owner or investor that currently has predominantly C or D rated stock may take the view that there is an adequate margin to mitigate the potential risk of being left with un-lettable properties. However, it is possible that the current ratings paint a worse picture than at first appears.

There are several key questions to consider. Timing is arguably the most critical factor. EPC's produced shortly after the legislation came into full effect (2008) were of a lower quality, reliant on default settings and susceptible to having optimistic ratings. EPCs created at that time also do not take into account changes to Part L of the Building Regulations.

It is widely acknowledged that radically improving the energy performance of existing buildings is essential to reduce greenhouse gas emissions and meet associated targets such as those set by the Climate Change Act 2008 (34% and 80% reductions by 2020 and 2050, respectively).

However, the likelihood that at least 2 out of 3 buildings around today will still be with us in 2050 reinforces the significant role of existing buildings. Government is ratcheting up energy efficiency requirements to move towards an ultra-low/zero carbon built environment. That can be seen in recent and future changes to Part L. The last revision resulted in an increase of 20% in the carbon emission reduction requirement; similar changes take effect in 2013 and 2016.

The cumulative effect of all this may push a current C or D rated asset to an E. Hence, a C or D rating today does not look future-proof.

There are numerous examples of policy uncertainty; changes to Carbon Reduction Energy Efficiency that ultimately become a carbon tax or more recently, the slashing of feed in tariffs. In addition, Government acknowledges improving the energy performance of historic buildings is challenging and that may result in a relaxation of the regulations, putting more pressure on other assets to balance the books.

Limited evidence in the UK that energy efficient buildings command higher rents or purchase prices may dissuade investment in improvements. With Government proposing that by 2019 new commercial buildings must be zero (or more realistically, ultra-low) carbon, it remains to be seen how existing buildings will perform. We predict that discounting of rents and sale prices will occur to reflect their poorer energy performance.

Perhaps poorly performing properties will become un-lettable or un-sellable, not because of legislation but because of market factors. There are signs in the marketplace that investors are unwilling to hold properties with an EPC lower than a D. If greater discounting does occur the prospect of increasing property value by investing in energy efficiency improvements will create opportunities for less risk averse investors.

Uncertainty surrounding future Government policy and legislation undermines confidence when making decisions to invest in energy efficiency improvements with long payback periods. Having said that, their longer-term targets remain unchanged and the UK has signed up to EU's Energy Efficiency Directive. Ultimately, legislation will be used to drive down property-related emissions to achieve these legally binding long-term targets. If the market does not respond and we do not meet the targets, more legislation will inevitably follow.

The conundrum is what (if any) action should be taken. Doing nothing is certainly an option. But risky.

A more pro-active approach would anticipate the potential impact of longer-term policy objectives and targets on property values and liquidity. By making your buildings more energy efficient, they become less susceptible to energy supply and price fluctuations. This will be highly attractive to potential occupiers, ensuring their future.

For more information contact Mat Lown mlown@tftconsultants.com

Mat Lown is a member of the RICS Sustainability in Existing Buildings Practice Standard Working Group and a lead author of the Sustainability Guidance Note used by RICS members. He is also Head of Sustainability at TFT.

DOING NOTHING IS CERTAINLY AN OPTION – BUT RISKY

DAN HENN
PROJECT CONSULTANCY

TIPPING THE VIABILITY BALANCE: DOING MORE FOR LESS

The property market continues to face significant challenges. These include the Euro-zone crisis impacting tenant demand in the UK, particularly outside of the South-East, legislation affecting development viability and even the Portas review. Conversely, the market also continues to present major opportunities.

With our relatively stable economy, transparent legal system and being English speaking, the UK's property market is seen as a haven for foreign investors, from high net worth individuals in ailing economies to sovereign wealth funds in the emerging countries.

We have seen the success of the Olympics and the amazing impact which that had on the property sector as well as the economy as a whole. Huge swathes of east London have been regenerated and a programme of work continues. Legacy of projects are planned to be rolled out over the coming years, including residential, student housing and mixed-use developments.

Crossrail is targeted to complete in a few years timeW and the signs of this massive infrastructure project are everywhere in the capital as new bridges are constructed and new or extended stations pop up. Savvy investors are eyeing up properties to acquire in the enclaves around the new Crossrail stations where property prices are set to increase disproportionately.

Over the next two years, we will see a record number of leases expire in the office sector. In London and the South-East, there is a stronger demand for office space and this presents serendipitous opportunities for investors and developers, particularly in areas where there is un-realised asset management potential.

Outside of these areas it is more of a challenge, particularly in out-of-town business parks, as the demand moves towards town centre locations with good transport links. This contrasts with town centre retailing, which struggles whilst out-of-town destinations continue to grow. Retail parks developed in the '80s and '90s often have good asset management potential with opportunities for extension and reconfiguration.

Exploiting these opportunities and managing the risk is part and parcel of the overall investment strategy, but coupled with this, the investor or developer must have an understanding of some of the wider technical issues which can affect viability.

These come in the form of the new Community Infrastructure Levy, provision for affordable housing on commercial schemes and the forthcoming changes in Building Regulations which will translate into additional project costs. Further along the road in 2018, buildings having an EPC rating of G or H will not be marketable for letting or sale.

Older building stock often has great benefits such as speed to market, retained structural elements and good parking ratios, although this needs to be balanced against building obsolescence issues such as dealing with the building's cladding, life expired services and poor architecture. As our clients continue to navigate their way through this minefield, the opportunities for us as project consultants to help them have never been greater.

Today's challenge for clients and their advisors lies in making sure that the scope of the works is appropriate to the condition of the building and also market expectations. For example, there is no point seeking to refurbish a 1980s VAV air conditioning system in a prime office building in the City of London if the market expectation is for new equipment to attract a blue chip tenant. Conversely, the approach to dealing with a similar VAV system in an out-of-town business park may be to undertake a simple refurbishment of the system to obtain a 10-year letting from a tenant market that is much less discerning.

The 'one size fits all' approach is no longer appropriate in the current market and, as technical project consultants, we must continue to challenge everything. Is the specification right? Does it match market expectations? Does it need to be replaced? Is there an alternative? Can it be done quicker?

As well as considering current life expiry issues we must also anticipate potential obsolescence throughout the building's life cycle. Clients are now looking more closely at cost-in-use as they must demonstrate to prospective tenants that the premises will clear due diligence or that service charge costs over the duration of the lease will be in line (or below) the competition.

With the changing dynamic of shorter leases, clients will need to forecast their position (and their dilapidations situation) possibly only five years after the initial refurbishment. In short we need to make sure your projects are doing more for less!

For more information contact Dan Henn dhenn@tftconsultants.com

NEIL GILBERT
DILAPIDATIONS

NAVIGATING THE PATH TO SETTLEMENT

A perfect storm of ageing building fabric, finishes, systems and changes in occupier need are all conspiring to create the current climate of building obsolescence.

No sector is immune. Offices with unworkable floor-to-ceiling heights. Inefficient floor plates which are out of step with occupier's requirements. Poorly insulated roofs and outdated windows delivering poor thermal performance.

The life expectancy of M&E installations has dropped from around 50 years to 15. M&E systems can be relatively inefficient and legislation such as the ban on HCFC R22 refrigerant gas which is due to come into force in 2015 will all create real challenges, for landlords, tenants and their advisers, particularly in multi-occupancy buildings. This is leading landlords to reconsider their options to safeguard the future of their properties.

Redevelopment is one such option, with landlords now considering demolition or substantial modification of a building that has become obsolete to protect its future and attract a new occupier.

Change of use of a building which has become obsolete in its current form is also becoming more commonplace. A typical example is the conversion of offices to residential use, particularly to student accommodation or hotel use in city centre locations. Such changes have a significant impact on lease-end dilapidations.

Care must be taken to establish any aspects of a landlord's claim that are not to be altered and may still be valid.

Landlords must make certain that their dilapidations surveyor is fully briefed on their intentions for a property at lease end, to ensure the terminal schedule of dilapidations is reasonable and fully reflects those intentions. Openness and honesty are demanded by the Dilapidations Protocol.

Tenants who occupy potentially obsolete buildings where they suspect the landlord plans to go beyond a simple scheme of repair and redecoration must serve a response to terminal dilapidations that states this assumption, along with a reasonable offer to settle. Where redevelopment is to take place, a tenant may still have a dilapidations liability to the landlord for the removal of alterations and any chattels, but their repair and redecoration liabilities may be much reduced or even negated.

Another agent of change is the trend towards shorter leases, with the average lease length now only 4.8 years according to the latest BPF/IPD Annual Lease Review.

This doesn't actually accelerate the decline in a building's economic value or directly influence obsolescence but does present landlords with more frequent opportunities to upgrade properties. This upgrading is essential to meet the changing needs of occupiers and maintain a competitive market edge. For landlords of multi-let properties, the key to attracting and retaining tenants is a rigorous planned preventative maintenance programme and more active management of their assets.

The dilapidations arena will undoubtedly see further changes as more Green Leases are implemented. These will promote collaborative landlord and tenant relationships to address unsustainable reinstatement requirements and encourage tenants to plan a more eco-friendly fit-out.

However, the dilapidations process is not a tool to fund the regeneration of an underperforming building. Methods of building repair can involve an element of betterment and this may affect the landlord's chances of recovering costs from a tenant.

A tenant does not have a liability to safeguard the future of a building; only to rectify breaches of covenant that exist up until lease expiry. Shorter leases often dictate greater tenant protection for dilapidations, in the form of schedules of condition, specific exclusion from liability and service charge caps.

So dilapidations is not a panacea for profit; it will return the building to the condition dictated by the lease covenants but not to an as-new condition. With buildings being returned to the landlord in no better state (or specification) than that demised, the obsolescence challenge is compounded.

Emerging from recession, the next major hurdle will be for landlords and tenants to address the whole R22 refrigerant gas issue, and the works necessary to deal with this legacy. Landlords of multi-let buildings may seek to recover the cost of any works through the service charge; tenants will want to resist this. As a result, greater numbers of service charge disputes are inevitable and the role of advisors will become ever more crucial.

For more information
contact Neil Gilbert
ngilbert@tftconsultants.com

RICHARD AITCHISON
PROJECT MONITORING

FUTURE LEGISLATION MAY UNDERMINE TODAY'S FUNDING DECISIONS

Future building obsolescence is radically changing the way that property funders and investors approach their lending and investment decisions.

In our view, real estate finance lenders will need to reassess their lending strategies to minimise the obsolescence risks associated with sustainability. To achieve this, the role of the independent monitoring surveyor will become more critical to ensure that any development or investment loan is not compromised by potential building obsolescence.

Taking a typical 5 year development or investment loan for example, it is will be important to ensure that borrowers have a means to pay back the loan on expiry. Legislative changes from April 2018 will mean that all residential and commercial properties that have an Energy Performance Certificate Grade F or G will be, by law, unable to be marketed for rent or sale. Thus commercial landlords will need to re-assess the energy efficiency of their properties and carry out improvements prior to marketing them. If not they will potentially be faced with an empty, unusable property in 2018. This will have a significant impact on the valuation. Therefore lending and investment decisions need to consider this now.

With a building's sustainability credentials now firmly on investors' acquisition and divestment agendas and their minimum performance expectations aligning with occupiers' demands for more sustainable space, the technical due diligence role needs to recognise and report on this performance criteria as a key aspect of fund monitoring. The role of the independent monitoring surveyor needs to consider the wider agenda of building flexibility (such as the layout, footprint, ease of refurbishment, demolition) as well as energy costs and they will need to provide expert advice in all of these areas.

An important consideration, and an often hidden challenge for investors, is the MEP installation. The broader viewpoint of the independent monitoring surveyor also needs to understand the approaches to Corporate Social Responsibility (CSR) and sustainability issues, together with the overall corporate attitude to energy.

As independent monitoring surveyors, we use widely recognised measures of a building's environmental performance such as BREEAM and LEED to help investors and funders understand their building's sustainability credentials and likely marketability. So, the emerging marketplace, where sustainability is key and building obsolescence has major consequences for potential property funders and investors, calls for new considerations.

For the independent monitoring surveyor, the need to see the bigger picture is crucial, taking into account building life cycle issues, the risks associated with an unsustainable development and its future as a portfolio asset.

For investors, fund managers, occupiers and real estate finance lenders, there is a need to look ahead and to have the independent monitoring surveyor alongside to mitigate risk and avoid future building obsolescence impacting on the value of their portfolio.

For more information
contact Richard Aitchison
raitchison@tftconsultants.com

Richard Aitchison is a member of the RICS working group on Project Monitoring and is a major contributor to the Project Monitoring Guidance Note used by RICS members. He is also head of the Project Monitoring Working Group and Head of Construction Lending Support at TFT.

A GLASS HALF FULL – THE FUTURE OF THE OFFICE

RICHARD KAUNTZE

Commentators often like to remark that "we live in an age of change". Perhaps more relevant is the pace of change, which seems with each generation to be ever more rapid. Some buildings (say, the Georgian House) have stood the test of time better than others. But what of the office? In its current form it has existed for little more than a hundred years, and yet many relatively modern buildings have become obsolete. What of the shiny new steel and glass towers which increasingly dominate city skylines? How will they fare in a few years time?

Obsolescence is widely regarded as not being the most glamorous of subjects in the property world, but is important none the less. Reflecting this, it was the subject of a major piece of research by the British Council for Offices (BCO) earlier this year: Change for the good – identifying opportunities from obsolescence.

What does the report tell us? Well, many things, but perhaps one of the most striking is that obsolescence, as a subject, is not well understood. This is more than a little surprising because a harsh critic of the property industry might put it into the class of the "blindingly obvious". The report revealed that institutional investors regard up to 15% of their office portfolios to be obsolete. It is obviously, collectively, a vast amount of space, and yet the problem with these redundant buildings is often simply ignored. To add to the potential gloom, it may well get worse! Large corporate and public sector office occupiers are not looking to increase their office requirements, but to reduce them, principally, of course, to save money.

Why should it be so surprising to anyone that, coming back to "the age of change", space requirements are different. Relatively modern buildings can all too quickly become tired or unattractive at best, or simply no longer fit for purpose at worst. Drive around the outskirts of any city in Britain and one is bound to see vacant space where the chances of securing a tenant look, on the face of it, to be virtually nil. Most of these will be 1960s or 70s buildings which nobody really wants, but a fact which the market is not quite prepared to accept.

But is the picture really quite so stark? Is the wrecking ball the only answer? For some, undoubtedly so, but others present a significant opportunity for re-development, not least because of the enormous environmental benefits of renewing and re-using existing stock, rather than simply replacing it.

The fringe location of many of these buildings is generally a highly significant problem. Whereas in the 1960s, 70s and even 80s many businesses looked to out-of-town locations, more and more now want to be in the city centre. People, particularly young people, generally wish to work, play, eat and sleep within a relatively confined area (well illustrated by the huge growth in the residential population of cities such as Manchester and Leeds in the last 10 to15 years). But not everyone can be accommodated in the city centre and some, particularly at an attractive price, may be tempted to live in former office buildings if they could successfully be converted to residential. Nationally, the conversion of commercial to residential buildings in recent years has been miniscule. Often, particularly in London, these buildings were designed to be residential in the first place (back to the Georgian House).

Our old friend the planning regime again comes into play. At the moment, saying that navigating this aspect of the process was "difficult" would be more than generous. Surely the government could do something quickly to encourage change. Here is an opportunity to "green" the UK office stock in its broadest sense.

I am often asked whether the office has a decent future. Clearly, anyone running the BCO is probably predisposed to say "yes", but with me it is always "yes, but". Offices will continue to manifest themselves in different forms, and evermore rapidly. What used to be regarded as retail space (such as high street cafes) are, in many ways, now de-facto offices. This is particularly the case in parts of cities with large financial centres.

Many large and complex organisations continue to require state-of-the-art, very highly specified buildings, but others will be content with something older, or more modest. Re-invention is the fundamental, and re-use, be it residential or hotel as prime examples, must be the most sensible options where there simply is no continuing demand for an office. So, be inventive! Here is an opportunity.

Richard Kauntze is Chief Executive of the British Council for Offices (BCO)

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OUR OFFICES

BIRMINGHAM
8th Floor Bank House
Cherry Street
Birmingham B2 5AL
+ 44 (0) 121 644 4000

BRISTOL
16 Queen Square
Bristol BS1 4NT
+ 44 (0) 117 934 99 00

CARDIFF
8 St. Andrews Crescent
Cardiff CF10 3DD
+44 (0) 29 2039 0099

GUILDFORD
65 Woodbridge Road
Guildford GU1 4RD
+ 44 (0) 20 3479 7777

LONDON
2 Throgmorton Avenue
London EC2N 2DG
+ 44 (0) 20 3479 7777

MANCHESTER
Peter House
Oxford Street
Manchester M1 5AN
+ 44 (0) 161 228 2727

Design by Bison Bison
www.bisonbison.co.uk

TFTCONSULTANTS.COM