Meadow Partners' Andrew McDaniel on The State of the London Office Market

How does London office vacancy compare to the U.S, historically and today, and what does that tell you about the market, particularly in terms of supply constraints?

London vacancies are almost always significantly lower than comparable international markets. Market vacancy commonly stabilizes in the 5% range within our core office markets. London's extremely limited supply of land and cumbersome land use system that makes development slow to respond to price signals is an additional benefit. These factors in the post-Covid environment are resulting in even lower supply than usual with a minimal forward pipeline (less than 1% of existing stock) of development deliveries expected over the next three to four years which are further complicated by elevated interest rates and construction cost inflation.

The occupational market is really turning now. Major occupiers have significant pent-up demand – many are facing too little space following mistaken Covid-era expectations – with few options existing to move. We expect that what were very recently 4- to 5-year forward projected prime rents will end up being achieved in the next 12- to 24-months. These factors are leading to the most compelling office investment environment that I have seen in nearly 25 years of living in London.

What has happened with employment in London compared to pre-Covid?

The story starts before Covid with Brexit actually, which was widely projected to erase numerous financial and professional services jobs in London. However, those projections never materialized because London doesn't have a direct competitor in Europe capable of absorbing its depth of talent, which meant the impact of Brexit was far more muted irrespective of bad policy decisions.

The market anticipated that Covid would be a second major blow and leave a wide swath of redundant central London office space. Instead, office jobs in the City of London have grown approximately 25% versus pre-Covid levels, an astonishing feat against all projections otherwise.

What that shows us is that London's employment base is genuinely diverse, dynamic and resilient. It's proven to be a durable competitive advantage, not just a talking point. It insulates the office market from the kind of sector-driven demand shocks that have hit other cities much harder.

What is happening to rents in London, and are current levels sufficient to justify new development?

Rents are rising, but they haven't yet reached levels that justify large-scale new development. Construction cost inflation has been severe enough that, even with meaningful rent growth, we estimate rents still need to meaningfully increase before they trigger a significant supply response.

That gap between where rents are today and replacement cost is, paradoxically, one of the most important features of the investment case. It means that even as rents move toward replacement cost over the medium term, the price signal doesn’t translate to immediate new supply because of the lack of space available and the difficult development environment. The price signal and the supply response are fundamentally decoupled in London in a way that simply doesn't exist in most other markets.

Buying existing assets is the best and one of the only ways to access forward rental growth potential, which is only truer, when viewed on a risk-adjusted basis. Acquiring well-located, tenanted buildings at discounts to replacement cost gets you the same upside with a fraction of the risk.

Do you see opportunities broadly in office across Greater London or, like NYC, is the demand concentrated in certain areas and for specific products?

We are highly focused on central London offices and established, core locations. We are targeting 100,000 square feet or more, Class A buildings with top-quality international tenants in-place. The current environment is creating the ability to buy existing buildings at significant discounts to replacement cost which is atypical in London but is the most compelling opportunity available now.

We're pairing that with a deliberate strategy identifying high-end corporate users, leading law firms, and other strong-credit tenants that have leases expiring over the next four to six years. We’ve already made two office investments and are using our long-standing market presence to generate more targeted investment opportunities across our opportunistic funds and SMAs.

How are Meadow’s investments, such as One Wood Street, informing your views of the London office market?

One Wood Street is a microcosm of what we see playing out across the London office market broadly and reinforces our conviction that compelling opportunities exist to invest in well-located London offices where the underlying demand remains strong. The Grade A building sits on a prominent island site in the heart of London between the Bank of England and St Paul’s Cathedral, and offers excellent natural light and floor-to-ceiling windows that allow for sprawling views of the surrounding areas. The property is a prime asset in a market where high-quality supply is increasingly scarce, and higher rents can be commanded.

Tenants increasingly want to work in the best buildings in the best locations, but there is simply not enough new supply coming through the pipeline to satisfy tenant demands. Planning and regulatory delays, construction costs and the availability of development capital are all making it increasingly difficult to add new office space in London.

One Wood Street is an exciting and particularly interesting investment because it not only illustrates, but allows us to take advantage of, the disconnect between demand and rents. Existing office rents in London are significantly below prevailing market levels, while demand for high-quality space continues to strengthen. One Wood Street serves as an opportunity to own a great building at an attractive basis, while benefiting from the rental growth we see.

How are UK lease structures different from what you see in the US?

The standard UK office lease is arguably the best in the world. To start, UK leases have longer dated lease terms of 15- to 20-years rather than 10-year terms found in other cities. Landlords benefit from net rents unlike gross rent, which is commonly found in most other markets. Building operating costs and real estate taxes are paid directly by tenants, a great inflation buffer.

Tenants are also required to pay repair costs and replace the building façade through the life of an asset, which further reduces future Landlord cost exposure. Put it all together and these office investments offer a cash flow stream that is longer in duration, lower in volatility, and are structurally positioned to capture rental growth. That makes UK office assets more attractive on a risk-adjusted basis than a surface-level yield comparison to other markets would suggest.