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THE PROPERTY MARKET APPROACH TO USE CLASSES

by

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The Law Society
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1. Introduction

The conference organisers asked me if I would put to you an examination of the practical consequences of the GDO/UCO changes on investment property from the point of view of the investor. Behind the suggestion was an accusation that investors have not come to terms with the changes and have neither grasped an opportunity nor taken safeguarding steps against a threat.

My investigations find investors to be guilty as charged but in mitigation, firstly I wish to put it to you that the blame must be more properly attached to property developers as opposed to investors, and that the remuneration and ethos of an investor in the U.K. is geared to the fundamental presumption that exceptional risks will not be taken, and that they are not expected to explore the unknown.

Let me explain a little. In my world an investor has a prime source of finance: he does not have to borrow: he invests in any property or non-property outlet that offers a return that he feels to be attractive. In that since firstly it has to give a secure return and secondly it has to out perform inflation over a period of years. Conventional wisdom is that property will only make up about 10% of an overall portfolio, that no one property should speak for more than 10% of that property element, and that only 10% of a property fund should be in development as opposed to completed projects. With all this is mind the investor is unlikely to be an innovator. Change, when change takes place in the property industry, is more likely to be led by the would-be occupier or by the property developer.

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Within the institutional property market, spread and sector allocation are amongst the in-words, and are not only so in property but also within the gilts and equities sectors. Therefore policy issues will direct that the property investor spreads his cash between the various property sectors, and this first slide shows that of all funds I have been able to research who admit to a sector allocation policy, 78% still classify their holdings by describing them as either shops or offices or industrial. This categorisation was commonplace in the mid 70s which is probably the earliest reliable date on which property performance statistics were know. Only 22% of the funds show any policy of restructuring their categorisation to reflect for example retail warehousing etc., business parks or superstores, the first 2 of which are arguably children of the change to the UCO.

My view of the institutional investor goes a little further with a rather depressing comment that in the property market, as perhaps elsewhere, future investment policies have, at least until now, been framed by analysing past growth performance and projecting it forward. Therefore whenever new investment concepts have emerged, it has taken a little while for the properties involved to land up in institutional hands: - retail warehouses at the outset where left with occupiers or property companies, and the same is true of superstores. London Docklands in the early days did not attract institutional investors. Things are however changing. Firms like my own have invested enormous time and money into developing rental forecasting techniques to reflect a whole range of economic and market place projections. As they become refined and accepted, so they will surely widen investors and developers horizons.

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2. <u>The Market Place</u>

If we are to have a sensible discussion of the way ahead, I think it is important that we start from a similar knowledge base. I hope I may be excused if I repeat what is to many of you old hat. Perhaps the easiest way to cover the ground is to take a site which I suspect will be known to many of you, and to assume - however improbably - that it has been made available for development. The site I have chosen is the Courage brewery site just by junction 11 of the M4 at Reading. Let us assume that it has a surface area of 15 acres and you all know that it has the characteristics of being 15 minutes from the M25 and hence the remainder of the national morotway network. It possesses what to employers are the two key issues of, firstly, access to markets and, secondly, the availability of staff although in the Reading area that is <u>becoming</u> something of a probalem. If the site were available and if collectively we were the development team deciding what to build on it, our shopping list would produce firstly an expectation that the market place would accept the location as being suited to:

Housing
A food superstore.
A retail warehouse park.
A shopping centre.
Traditional industrial buildings or warehouses.
Convential offices.
Research and Development buildings.

Ten years ago in market terms the choice would only have been between retail, industrial and housing.
Almost overnight industrial demand, as defined in the 1972 UCO, disappeared and a mechanism had to be found to deal with out emerging new types of employment.

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If only because they are not convenient to this examination let us say no more about residential, a shopping centre, a retail warehouse or a superstore opportunity than to note that with consent the value of the site might be between £11¼/26¼m, but then go onto presume that consent is not available.

Taking then the remaining B8 and B1 uses, the physical characteristics are as follows. My traditional industrial/warehouse building will be a shed with maybe 15% of the floor space allocated to offices, it will command £5.50 per sq. ft. in rent, it will sell to an investor without difficulty to show the investor an initial return of 7.25% and there is land value prior to development of £850,000 per acre.

In contrast a conventional office development might be a 2 or 3 storey structure carrying a rental value of £17.50 per sq.ft. and equally readily saleable to the investor to show the purchaser a return of 6.5%. The land value is £1.5m per acre.

Then finally I get to the B1 research and development building, which in essence is left at ground floor level as unfinished open space intended for research or assembly or even storage. Some kind of office or fully fitted laboratory space will be at first floor level. The rent will be £12.00 per sq.ft. and we can now find a purchaser willing to acquire the investment at an initial return of 7% leaving a land value of £1.2m per acre. The estimates of rental value are not a reflection of cost, but a reflection of what occupiers will pay for the space. However in the case of the industrial or warehouse operator part of the rent level reflects the extent to which he is trying to meet the competition from the other two uses. In support of that I shaw you this graph which shows how warehouse rents in this area have climbed since the introduction of the use classes order. The top

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line shows my western corridor figure, and the others in their turn the RPI as a convenient measure of inflation and two other locations in the UK - Northampton where the impact of the change to the use classes in market place terms has been marginal and Norwich where is has been non-existent.

3. The Developers View

I suggested that the non-risk taking investor looked, at least in part, to the property developer or tenant for a lead in the market place. You will have seen from our brief look at the Courage site that the developer for his part has to choose to promote buildings that the physically unlike each other, and he has therefore to react to predicted tenant demand. I suggest he will following certainty rather than too much of a wing and a prayer. The developers dilemma between building design and not brought about by the changes in the use class order. The concerpt for example of high-tech buildings existed before the introduction of the B1 planning use class and the property market had to decide initially not as a planning issue but as a matter of judgement which type of building to put on a particular site. That remains a market place dilemma today: all the changes in the UCO has done is to make the options more available. In the early days high-tech was the province of the minority largely through lack of an understanding among the majoriity for the demand for space. The introductiion of the new B1 use class speeded up understanding rather as the enterprise zones speeded up development in Dickland and elsewhere. The factors that created the new market are as indicated on this slide. Employment in the service sector has increased by 14.1% in the last 8 years coupled wiith a decline over the same period of 24.3% employed in manufacturiing industries. In contrast, journeys completed by

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car taxi and motor-bike have increased by 30% in 15 years, whilst those undertaken by rail, bus and coach have stayed static in percentage terms. The move from public to private transport reflects and encourages property development out of town centres, and it has been enabled by the changes to the use classes order. Those who noted the change of circumstances more quickly than most included Sun Alliance - a hybrid of a property company and an investment institution - in its development of Kembury Park where prior to its scheme the natural land use would have been industrial - if a tenant existed - at a land value of £250,000 per acre, whereas the land value now is arguably £700,000 per acre. This next slide shows a building 3 miles from the centre of Cambridge which few of us would until recently have accepted as the Cambridge Headquarters of one of that City's leading firms of solicitors. It sits near Trinity College's science park, and now has a rental value of £15 per sq.ft. and a site value of £800,000 per acre. If you strip out inflation back to early 1987 the price per acre becomes £720,000, whereas at that time industrial land in that area would have been worth £300,000 per acre. As we have heard from Patricia Thomas, Local Authorities perceive industrial and manufacturing employment to be good and employment in offices to be bad. They have developed an interesting armoury of ideas to prevent Governments objectives being achieved, of which two of the more original are - firstly in Reading - a planning, or so called policy, has been adopted to resist the development of buildings on more than 2 storeys in height outside the town centre - and secondly - more widely - the market place requirement of one car space for every 100 sq.ft. of office space (as distinct from one space for every 1,000 sq.ft. of warehouse space) has been manipulated by the planning authorities limiting the number of car spaces permitted on the site, so that an office scheme becomes unlettable and is thus not built.

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It is I think worth pausing for a few moments to look at the other effect of the loosening up of the use classes order. Because there is now much more flexibility in the market, it may be argued that office rents in conventional town centre locations and elsewhere have not grown as much as they would have done otherwise, nor as much as they might otherwise have done in the future. Certainly our research shows that office rents have moved ahead slowly recently and growth is only slightly faster than inflation. Indeed the same is true of industrial rents. Part of the explanation is that following the basic rules of supply and demand, over the long period rental values in offices and industrial have moved in line with the cost of construction. But it is generally now easier to increase the supply of office and business space, and today this market moves from severe glut to famine, and rents do not follow economic indicators very quickly.

Our industry has yet to cope with the other aspects of the new buildings that are emerging from the changes to the use classes order. Argument continues about how to measure buildings - those who are used to dealing with industrial buildings measure what is called gross internal area (defined as the total area within the perimeter walls).

Those who work in the office market work on net internal areas (defined as the usable area exclusing columns, staircase, toilets and so on).

The second example of the effects of the loosening of the Use Classes Order is to attach some figures to the case of Savile Row mentioned by Pat Thomas. You will recall that the Savile Row tailors were concerned that their premises would be ideally suited for office use and that as a result there would be an increase in rent levels. By implication I have presumed they

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Were suggesting that they could not afford to pay as much as offices tenants and that in their opinion it was necessary or good arrangement for tailors to be housed in Savile Row. In his response the then Parliamentary Under Secretary at the Department of the Environment made in effect three points of which one is remarkably stupid.

1. He suggested that many tailors would be protected by User Clauses in their leases that limited the use of premises to manufacturing.

2. As a result he argued it would be up to 25 years before free market rents would emerge - presumably he was not worried about the rent review position, and at review he did not contemplate whether under the Landlord and Tenant Act on renewal the User Clause could or could not be changed.

3. He suggested that tailors accommodation was not in fact suited to office space.

It is about two and a half years ago that he made those statements so it is a little soon to see if his predications are correct, but as I see it over that period:-

1. The change in the number of tailors occupying accommodation in Savile Row has been a reduction of 3.5% - or a loss of 1 out of 29.

2. In February 1987, a typical rental for a tailors showroon and workroom was at the rate of £25 per square foot per annum whereas today it is £35 per square foot per annum - an increase of 15% per annum compound.

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3. Over the same period office rents in Savile Row have grown from £30 per square foot to £50 per square foot - a growth of 30% p.a. compound. In short the Secretary of State was correct in regarding the tailors claim as alarmist.

The only issue that my research has not covered is what has happened to the prices of suits in the intervening period but I am conscious that they have driven some of the customers out of Savile Row although I meet as many tailors at Ascot as I used to.

In leasing practise, the structuring of the user clause and the framing of the rent review provisions, from a management surveyors stance, have not been without difficulty.

We have of course for a little while now been anxious to ensure that the drafting of user clauses did not by its narrowness inhibit the rent that we could charge at review or on renewal. Such a simplistic statement however is not without practical problems. For example in the retail sector, the promoter of a shopping centre such as Milton Keynes has normally sought to control the tenant mix, apparently having little faith that market forces would not produce a line up of a hundred shoe shops and nothing else. On the other hand the owner of a single shop in a high street has not had the same concerns and in loose terms was happy to see the property occupied by the highest solvent and honest payer.

Some landlords have taken to inserting a particular sub-clause within the A1 Use Class as a means to regulate the user, and this practice has been heightened by the reduction of the Landlords power to control the destiny of this property by the workings of the Landlord and Tenant Act 1988.

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Just to try to put a measure of value of what is involved there seems to be something of a rule of thumb that a specified user in a lease on a shop in a shopping centre might reduce the rental value by 10% of 15%. The argument to achieve such a rule of thumb has not related to the value of the property to the occupier but more to its inflexibility in use. If however to go to the other extremity, I were the owner of this shop which is located in Kings Road Chelsea, its rental value today is probably of the order of £135,000 per annum. If however I had been careless enough to stipulate in the use that it could only be occupied for say the trade of a baker and confectioner, I would expect such a trader to be able to justify that the higher rent he could afford would be about £100,000. The capital value of the property firstly with an open user clause and secondly with a user clause constrained to that of a baker is perhaps £2.25m against £1.8m.

There is another stark contrast and perhaps a more real one in the non-retail sector. Let us imagine a light industrial building located near to the M.25 which as a consequence of the introduction of Class B.1 of the 1987 Use Classes Order may be used for office purposes. For such a purpose the rental value clearly could double. Conventionally most commercial lease contain assumptions to be made on review including the assumptions with regard to the permitted user. Presumably total silence on a permitted use would mean that the valuer should look at the actual use of the premises and, if different, the lawful use of the premises in planning terms. From the lessees stance therefore a wide user clause is hazardous and equally the landlord needs to be alert that he may find it difficult to resist his offices becoming industrial premises or vice versa.

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In investment terms, a would be buyer will probably want an open user clause unless he had redevelopment in mind at lease end. So far I have not been made aware of any examples where an open use clause has operated to a landlords disadvantage, but in making that statement I am taking refuge in blaming the Landlord and Tenant Act 1988 for the fact that some of the premises that I look after are now occupied by lessees of dubious covenent whom I might have been able to shut out if the User Clause had been tighter.

I have a nervousness about drafting User Clauses with reference to the Use Clauses Order only because of the potential unforeseen consequences of using such a reference. It is safer perhaps to define uses by a description with adequate provision for change of use to avoid rents being artificially depressed.

I have confined my conclusions to Part A and Part B of the Use Classes Order and my first conclusion is that I find that Local Authorities are in deciding applications for both business and shopping use managing to get around the freedom that the Use Classes Order was intended to bring about. We have heard already many of the devices used to try to narrow the B1 Classification, but perhaps we have not highlighted sufficiently the extent to which particularly outside town centres, Local Authorities are trying to limit the occupation of retail accommodation to suit the own perceptions. We are still getting Class A1 in particular broken down between retail warehouses, food supermarkets and in some authorities areas restrictions against particular types of retail warehouses. If the Secretary of State is determined in his approach, he should properly let it be known that developers who appeal against a bad decision by a Local Authority will not only get their cases handled quickly but with the totality of their costs awarded against the authority.

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Turning more specifically to Part B of the Order, the conclusions of four fold.

1. The Use Classes Order did not create demand.

2. It made demand-led development more likely to be permitted and achieved.

3. The existence of possibility escalated development activity and demand.

4. The B1 Use Class moved B2 and B8 occupiers away from London and a few other isolated areas such as the Thames Valley, creating a massive rise in land value in the areas they vacated.

A final conclusion is that if you will picture Great Britain in relation to the Common Market you will see that in terms of accessibility to markets, we are very much on the northern edge. You could if you like describe Great Britain as the Wigan of the Continent. Therefore, if we are to capture a fare share of those companies who can locate their European Head Quarters in one of a number of countries in the future, we have got to counteract our relative inaccessibility to markets by other attractions. Most certainly we have got to avoid any form of deterrent that might emerge from unreasonably restrictive planning law. Therefore, the widening of the Use Classes Order to enable modern science parks, business parks and the like to be undertaken in a way to appeal to international occupiers is an essential benchmark for the future and one of the main contributions made by the Use Classes Order - albeit I suspect unwittingly.

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4. Looking Ahead

New industries demand a new type of building. There is increasing dependence on attracting staff, diminishing importance of a city centre location, and increasing disregard of public transport. Elderly buildings, where ever located are inherently obsolescent and unable to cope with the physical of their occupiers. Safety at work, industrial espionage and the competition for employeers all lead to new design criteria. It is easier to undertake new developments on green field sites than to endure the hassle of converting or in some cases getting permission to demolish old buildings down town. There is a severe risk that this country will however develop too many high-tech parks. The 1992 legislation will open up competitive sites far more positively, and southern Europe in particular typified by the Sophia Antipolis development near Nice will be increasingly attractive to footloose companies. That is the region that is attracting new investment. It will be difficult to compete with such environments in our small crowded island, unless we can do so by fiscal attraction, simplified planning regimes or the availability of a better quality of staff than elsewhere. Market forces will therefore out weigh the planning flexibility of the GDO, but as time goes by the institutional investor will accept the new markets that are being created. The investor will continue to want to own a share of industrial and warehouse accommodation and the Government for its part has a clear need to ensure that such space is made available. I doubt whether market forces will achieve its aim for it.

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