

UK Cities DNA



Mapping out the Repurposing Journey: the Keys to the Kingdom

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The last of twelve insight papers in our UK Cities DNA initiative – putting real estate supply and demand in the context of the economic direction of travel.

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Mapping out the Repurposing Journey: The Keys to the Kingdom

WORDS: STEPHEN SPRINGHAM – HEAD OF UK MARKETS RESEARCH

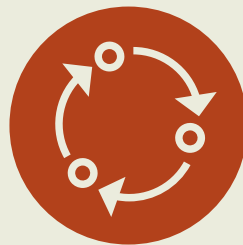
- Repurposing projects are highly complex, with very few quick wins. Many will not stack up financially and most will involve a difficult-to-navigate journey.
- Valuations hold many of the keys, but the process is shrouded by the lack of “middle ground” transparency – a segment where many assets sit.
- Planning may be less a blocker than it may have been previously on account of reform to the system, with permitted development rights presenting more of an opportunity than a barrier.
- Development strategy is likewise a complicated and painstaking process to unlock the repurposing opportunity. Capital markets hold the key to any potential exit.

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Complex. Drawn-out. No cookie-cutter solutions. Bespoke and intricate responses required. A journey. A marathon, not a sprint. But navigable with the right know-how and guidance. The Keys to the Repurposing Kingdom in a nutshell.

As explored in the ‘The Three ‘Res’ – to Retrofit, to Refurbish or to Repurpose?’ Insight Paper, repurposing may not necessarily be the primary course of remedial action for a distressed, failing or obsolete property asset. But if refurbishment or wider asset management do not provide viable salvation, more drastic solutions will inevitably need to be investigated.

The ‘Five Great Barriers to Repurposing’ Insight Paper explored the manifold pitfalls that may line the repurposing journey – the doors that need to be unlocked to provide entry to the kingdom of rebirth, sustainability and prosperity. Here we highlight some of the keys that may facilitate this journey.



Key 1. Valuations – “The Driver”

VALUE IS SIMPLE. VALUATION IS COMPLEX.

In the world of commercial real estate, offices are more than just buildings

– they are complex workplace ecosystems. The same thought process applies to other real estate uses. For example, a shopping centre forms an intrinsic part of the fabric of a town centre, the shops within it essential cogs within a supply chain system that also includes logistical warehouses. All property is part of a wider ecosystem.

As all real estate assets operate as ecosystems, valuing them is both an art and a science, relying on both data and intuition. And yet despite the challenge we face in appraising real estate, it is by no means an overstatement to say that value underpins everything. Period.

Value will underpin every strategic decision and it will unlock every initiative. But it is nevertheless a challenge that the valuation profession has to successfully navigate. While applicable to every asset class to a certain degree, offices perhaps offer the most pertinent case study and point of reference.

The property market at large tends to always think (or at least talk) in terms of a two-tiered system, but the reality is vastly different. The terms “two-tiered” or “polarised” market are a common currency, whatever the property use.

At one pole we have:

- new or recently refurbished buildings
- with the best amenities
- in the best locations
- meeting all ESG targets and aspirations
- setting leading rents
- achieving the keenest yields.

Here, we have price transparency because, by their very nature, they are in the pioneering markets. At the opposite pole we have:

- assets that are a product of structural, irreversible changes to either
 - occupier demand, or
 - regulatory requirements.
- making them no longer viable in their current form
- valuations will be driven by income + capital value per sq ft

Again, even at the opposite pole, we nevertheless have the comfort of price transparency as there is still liquidity at this end of the market. Although at the opposite end of the quality spectrum, there is a pool of opportunistic buyers who will adopt a value-add strategy.

But this polarity/dichotomy massively over-simplifies what the market is facing. The market is generally silent on those assets which fall between these poles or between these two tiers. And this ‘forgotten segment’ is not a small part of the market – it is actually the mainstay of the whole market.

From the perspective of a valuer, it is identifying and then valuing these ‘forgotten’ or ‘between two stools’ assets that provides the greatest challenge. These assets are those in a strong, but not best, location. They are generally well specified, but still require significant capital investment to meet market or regulatory standards. But the fundamental question is this – does the end value support the investment needed? Does it make financial sense?

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As ever, answering this question will require transactional evidence, but the challenge is compounded by the fact that we have been caught in an understandably stubborn period of limited price discovery. Well-documented economic and political headwinds have exacerbated regret aversion and stakeholder inertia – market inertia effectively caused by indecision. So, how will the market mobilise?

Reverting to the notion of offices/ any real estate assets operating as ecosystems, to understand the resilience of any ecosystem we need to have a deep appreciation of the environment in which it exists and the threats that it faces. This circles back to the very essence of this wider initiative – UK cities DNA. Will the long term, sustained (non-cyclical) occupational market, support significant investment? If it doesn’t, where is your exit and what form does that exit take?

Ecosystems are complex, solutions to threatened ecosystems are complex. And ultimately value underpins everything.



Key 2. Planning – “The Facilitator”

NOT ALWAYS THE VILLAIN OF THE PIECE

All too often the ‘Planning System’ is perceived to be the single most obstructive source of uncertainty and risk, a barrier or door that is well and truly locked. But this perception may be something of a legacy of the past that does not fully reflect the level of reform that has been implemented in recent years.

Planning, or rather the correct planning strategy, may actually be an opportunity to unlock latent

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value and repurposing potential. And this may well accelerate if the Labour Government remains intent on speeding up Planning and, in particular, boosting the supply of housing. The stated number one priority is 1.5 million new homes within its first term. Apart from residential, the government is also known to be keen on Gigacentres, Datacentres, Science, Research, Education and Technology. We are promised revised national guidance and new legislation that will speed up the planning process.

For all this progress, the Planning System is not short of challenges. Issues around local planning authorities resourcing are ongoing and there are still considerable inconsistencies in decision-making between different authorities (the protracted saga around the M&S Marble Arch store being a classic case in point). Short term politics need to be overcome, as do increases in cost and complexity of applications. Planning timeframes are prolonged and there is often a lack of control. This all adds up to uncertainty and this is tellingly reflected in the latest planning applications statistics from the Government, which show the lowest volumes for new applications since 2012.

That said, repurposing is generally supported by Planning Authorities and stakeholders. With no demolition required, repurposing projects minimise carbon usage and help achieve net zero objectives. Delivery is often more rapid compared to new build schemes. New flexibility within Use Class E captures many alternative and hybrid uses that previously would have required a formal change of use such as converting Office space to life

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science, R&D or hybrid education uses. The same applies to retail being converted to multifunction leisure and food & beverage operations.

Fewer restrictions on Permitted Development Rights to facilitate housing are also allowing upward extension of existing buildings and conversion of office blocks. Correspondingly, there has been an explosion in interest in the market from landlords and investors keen to understand the potential of Permitted Development Rights to convert commercial premises to residential, especially since the removal of floorspace threshold and need to demonstrate vacancy that came into force earlier this year.

The attraction of PD is that:

- it has fewer planning policies to satisfy and thus there is less scope for objection or debate
- it has a 56 day determination period
- it currently has no affordable housing obligations.

However, there is seldom a “one size fits all solution” and the correct strategic advice is paramount to maximise return and unlock value:

- PD may be the best option. It avoids affordable housing contributions and is quick to secure via planning (eight weeks). But it can also fetter your interest.
- Explore alternative uses first - conventional commercial office use to hotel, leisure, hybrid educational, life sciences have also been popular. But student accommodation and co-living may not be achievable, if banking a PD scheme first.
- Even where PD to Residential is the best option, there may be wider strategic opportunities e.g. PD

Plus options to amend or extend the property (adding things like balconies and larger windows, or upward extension)

- Or banking PD and then coming back with a redevelopment scenario.

But it is important to act soon, before Planning Authorities introduce blocks on PD (article 4) or Government adds an affordable housing requirement.

Planning – not necessarily the hurdle it is perceived to be, perhaps even an opportunity creator.



Key 3. Development Strategy – “The Enabler”

MAKING THE OPPORTUNITY HAPPEN

What to do when the CAPEX required means that it is simply not viable to refurbish the property to meet the regulatory and functional requirements of its current use? What next?

We’ve already established that value underpins everything and it will underpin every strategic decision. Where valuation professionals identify that a property simply won’t stack up, we need to think outside the box to find the new value and breath new life into the ecosystem of the asset.

This may entail a complete change of mindset, a complete challenge of what we think an asset could and should be. We are increasingly seeing obsolescent office buildings being repurposed or redeveloped into student housing, residential, Build To Rent homes, hotels, care homes – and new sectors like co-living or co-warehousing. And any number of combinations of the above.

But is this necessarily the key to the proverbial kingdom? Again, if

only it were that straightforward, it’s a complicated multi-faceted process which will provide a solution, but with no small journey to get there. Over and above the planning considerations, there’s also the fabric and layout of the building itself and location and City DNA to factor in.

Breaking it down and mapping out the journey, we can take a hypothetical example.

Step 1 – Office building A is located in a city location – the City DNA tells us that rents and demand for offices are falling and valuations have identified that the value of the asset does not support the CAPEX required to bring it up to the required standards.

Step 2 – A high level planning overview is undertaken to check whether Permitted Development is an option and establish what alternative uses might be feasible in the location from a planning perspective.

Step 3 – Explore uses which might work and with feed-in from relevant sector specialists, analyse the different options to establish suitability of location of Building A, establish which use derives the greatest value and sense-check market demand (remembering that value underpins everything).

Step 4 – Employ Building Consultancy specialists to understand the extent to which Building A can be repurposed and explore whether redevelopment the right solution.

Step 5 – Form and execute the business strategy. There are many factors which inform how a landlord may want to exit an asset – or not as the case may be. These all need to be considered to establish whether they

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1) Sell unconditionally. 2) Sell with the benefit of an architect feasibility study and a positive pre-app – all the way through the risk / return curve to assisting in the process of developing out and selling the finished product.

A pathway rather than a “one size fits all solution”.

CAPITAL MARKETS – THE ENTRY AND/OR EXIT POINT

Capital markets can book-end the entire journey. Many landlords may embark on the repurposing journey by

default and out of necessity. Assets that they own may have become highly challenged or obsolete as a result of factors that we have already identified. Some landlords may not wish to go down the repurposing route themselves, either through lack of motivation or, more likely, through financial constraint.

One man’s trash is another man’s treasure. Other investors may be looking to opportunistically acquire problem assets with the aim of unlocking full repurposing potential. Some are proactively looking to ‘buy into the problem’ and embark fully on the repurposing journey themselves, either alone or in partnership with other parties from either the public or private sector.

At the other end of the journey, capital markets are obviously also integral to any exit strategy. The finished product attracting broad investor interest from a wide base, with keen pricing to match.

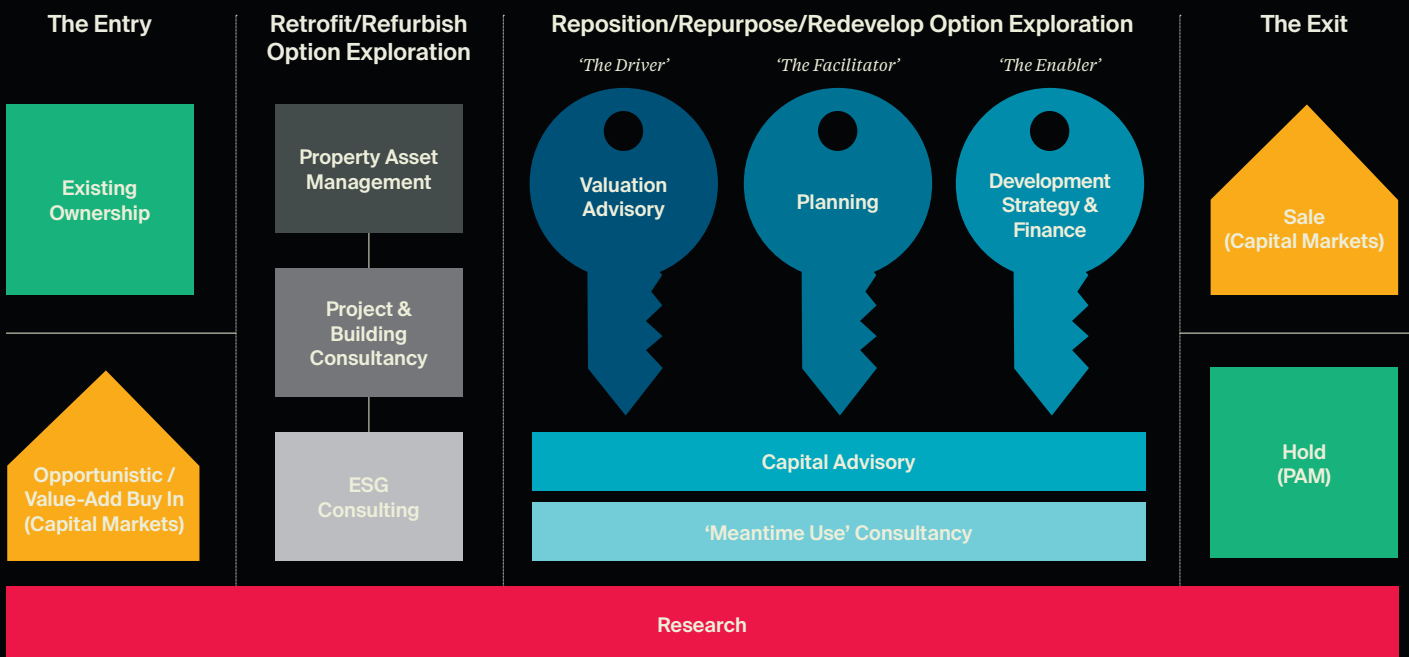
CONCLUSION

A journey fraught with complexity. But a navigable one with the right vision and strategic advice. And built on the firm understanding that value underpins everything.

Maybe not the keys to the kingdom of heaven in the true biblical sense. But the keys to the kingdom of relevance, sustainability, environmental compliance, social inclusion, strong property performance and decent return. An alternative heaven in the context of a problem asset that is currently, or at risk of becoming, obsolete.

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‘The Keys to the Kingdom’



We like questions, if you've got one about our research, or would like some property advice, we would love to hear from you.



Stephen Springham
Partner, Head of UK Markets Research
stephen.springham@knightfrank.com



Darren Mansfield
Partner, Head of UK Offices Research
darren.mansfield@knightfrank.com