

UK Cities DNA



Oversupply or obsolescence?

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The ninth 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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Buzzwords or trap?

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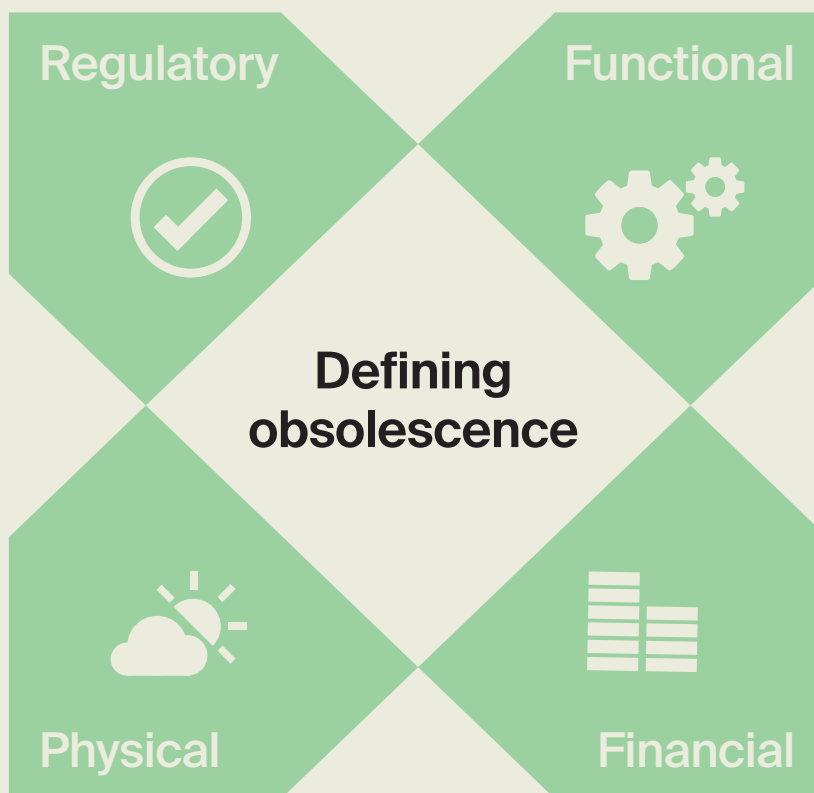
The two terms – oversupply and obsolescence – are both intertwined and increasingly complex. To determine the optimal use for an asset all angles of each need to be assessed and quantified on a hyper localised scale. Here we define the terms and highlight market evidence behind the key risks.

- **Oversupply and obsolescence – industry buzzwords, but actually complex concepts which are often intertwined – but are also binary and can operate as distinct forces.**
- From an ESG lens, there are four key obsolescence risk categories – Regulatory, Functional, Physical and Financial. These ESG-related risks are conflated by wider market forces, such as occupational demand.
- Oversupply varies dramatically between property sub-sectors and individual markets. Nationally, Retail is acknowledged to be heavily oversupplied, while the supply of Industrial is more in balance with demand. Offices sit in a nuanced position between these two extremes.
- Oversupply and obsolescence are hyper-localised and often asset-specific. A brand new, high spec, fully ESG-compliant asset is still obsolete if unlet with no prospect of occupational demand.

Building obsolescence is nothing new, yet the pace has been accelerating, driven by evolving regulatory, physical, financial and functional risks relating to sustainability, conflated by changing requirements for real estate. Whilst defined in isolation, these risks are interlinked, complex and already driving investor and developer strategies. For example, just over three-quarters of European investors polled in our summer *2023 ESG Property Investor Survey* are looking to improve the quality

of their existing portfolios through refurbishing, retrofitting and repurposing projects.

Over and above this, 58% are actively seeking to acquire poor ESG-performing assets to improve/upgrade, opportunistically buying into the problem. Even so, obsolescence is not yet fully understood – or fully priced in across the market, which may provide an opportunity for those investors who are able to get ahead of the curve at recognising and managing obsolescence risks.



What do the four obsolescence risk categories mean?



1. Regulatory

Risk of not meeting regulatory or legal requirements. In the UK, the Minimum Energy Efficiency Standards (MEES) require commercial buildings to have a minimum Energy Performance Certificate (EPC) rating of E to be lettable from 1 April 2023. There are proposals to raise this minimum to a C rating by 2027 and a B rating by 2030 – although timelines and implementation have yet to be cemented.

2. Functional

Split into three areas: sustainability, economic and location.

From the sustainability sense, this relates to the shift in tenant preferences and the risk that a building no longer meets occupiers' ESG needs.

The economic angle relates to the change in the economic makeup influencing the occupiers e.g. for offices a shift from financial occupiers to life sciences – which require different types of space or the need for more logistics facilities and therefore change of use.

Locational is where the asset's exact location matters due to being in certain districts or type of area e.g. a Business Park in/out-of-town or in central business district.

The latter two of these three can be a more structural shift and can be assessed through looking at over/under supply.



3. Physical

On a macro-level, those associated with climate change effects can face two types of risks which have impacts for property owners and the functional performance of buildings:

- Acute - event-driven, including heatwaves, hurricanes, or droughts – where warmer summers can add stress to air conditioning units and reduce thermal comfort, or heavier rainfall may not be manageable by guttering systems, causing flooding.
- Chronic - long-term climate shifts, such as temperature changes, sea level rise, or soil erosion – which can, for example, lead to subsidence.



4. Financial

This relates to access to and cost of insurance and financing. With rising physical risk, the cost of insuring buildings is increasing, and, in some locations, the availability is limited or absent. Financial regulations mean that lenders are assessing loan books on exposure to climate change emissions and incorporating climate risk assessments into their lending practices and portfolio management. Both insurance and financing rates could feed through to asset valuation and returns through changes in operational expenditure.



Within each of the types of obsolescence there are key considerations for asset owners which we will highlight with some market evidence. This is discussed in greater detail in *Meeting the Commercial Retrofit Challenge – Part 1: Defining a Decarbonisation Strategy*.

- **What is the regulatory risk of obsolescence?** Getting ahead of potential future regulation could provide a first-mover advantage, particularly where there is a demand and supply imbalance.

- **What are the local market dynamics?** What is the demand and supply for that type of asset, assessing the use and sustainability criteria?
- **How might this change with future occupier needs?** What will tenants require in 2/3/5 years? Will net zero targets and amenities become mandatory?
- **What practical actions would need to be taken to ensure that the asset is optimally positioned?** What can be done to meet regulatory requirements, what level of amenity

of and sustainability is required? What will the future occupier businesses need?

“Building obsolescence is nothing new, yet the pace has been accelerating, driven by evolving regulatory, physical, financial and functional risks relating to sustainability, conflated by changing requirements for real estate.”

Regulatory obsolescence risks

The proposed changes to Minimum Energy Efficiency Standards (MEES) have been in limbo since 2021. The new UK government has pledged to implement stricter MEES in the domestic private rented sector by 2030, which may indicate the direction of travel for the non-domestic sector too. Regardless of all this uncertainty, the industry has largely taken the minimum as a given and it has become a strategy for many investors, according to our *ESG Property Investors Survey*.

Some 70% of commercial property floorspace is currently rated EPC C or below and at risk of being unlettable,

if the standards are implemented as proposed. The office sector is at the sharp end of this, with only one quarter of office stock in England and Wales currently meeting proposed MEES requirements of EPC B or higher. A further 29% are rated C, which may be an interim step, but this leaves almost half of the entire office floorspace in England and Wales with a rating of D or lower.

Compared to this, just shy of one third of the logistics and retail sector buildings have an EPC rating of B or higher in England and Wales. This still leaves the majority potentially facing tougher regulatory

requirements in the future. Regional differences also play a role, but the harsh reality is that all commercial property sectors, regardless of geography, are falling short.

LOCAL DYNAMICS

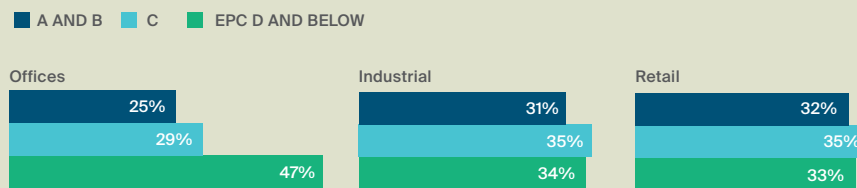
We provide in depth analysis of offices from a sustainability perspective in *Meeting the Commercial Retrofit Challenge – Part 1: Defining a Decarbonisation Strategy*. This report highlights the imbalance between MEES compliance and actual leasing activity. A key finding was that almost half of office leasing transactions across eight major cities in 2023 were for EPC A- or B-rated properties, up from 40% in 2019.

Here we focus on the functional obsolescence from an economic and location perspective, the changing economy and real estate requirements – all these factors need to be considered when forming an asset plan.

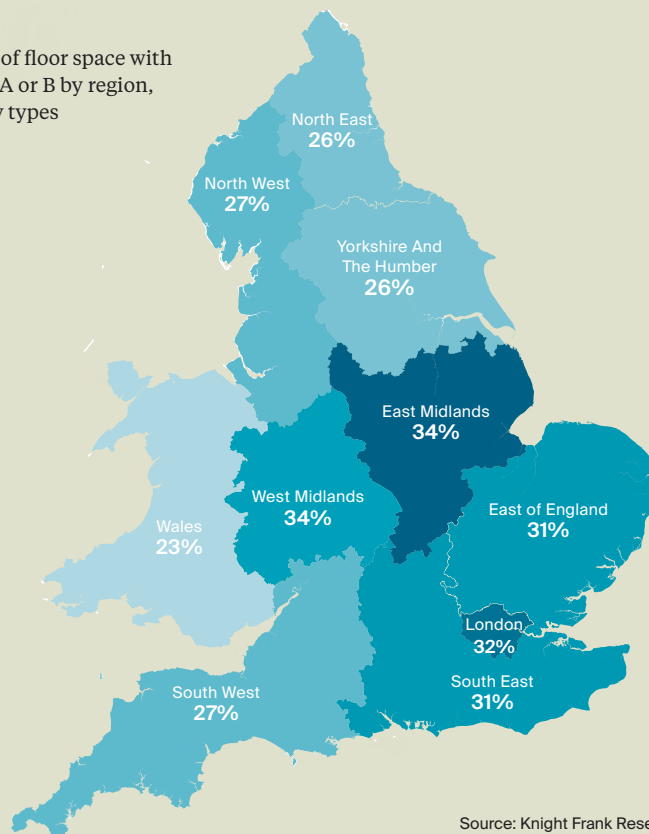
The asset needs to be assessed relative to the demand dynamics for each type of use (e.g. office, retail, logistics, residential); occupier type (e.g. life sciences vs legal for offices, pharmacy vs clothing for retail, last mile vs cold store for logistics etc.); sustainability specification (e.g. high level of amenity, certification etc.); and at that specific location. Having looked previously at sustainability certification, we also explore high-level market statistics for some of the use and occupier types – noting the intersection off all will be asset-specific and recognising this will be critical for formulating strategies.

Figure 1: Falling short

Proportion of total floor space by EPC band and property type



Proportion of floor space with EPC rating A or B by region, all property types



Source: Knight Frank Research, DLUHC

70%

of commercial property floorspace is currently rated EPC C or below and at risk of being unlettable, if the standards are implemented as proposed.

What level of office space is required – and where?

Supply levels are increasingly dynamic and fluid, with some locations, grades and property sizes experiencing oversupply, while others face undersupply. These nuances demonstrate the paramount importance of assessing each individual asset at the most localised level available. Here, we offer an overview of the market to shine a light on what is an intricate web of complexity.

REGIONAL VARIATIONS

At an overall level, we estimate that office stock in the major national markets will reduce by 47 million sq ft or 5% of total stock over the next ten years. The extent of over or undersupply in each market is exceptionally locationally-driven. To understand and highlight differences, we have aggregated data for more than 100 towns and cities to measure the time of supply for each market in totality, and of the highest (Grade A) stock specifically. The metrics essentially play off supply (current and future) with take-up dynamics.

Given the time taken to plan and build, we categorise each town and city in accordance with:

- **Under 1 year supply** – Critically Under Supplied
- **1-2 years** – Undersupplied
- **2-4 years** – In Balance
- **Over 4 years** – Oversupplied.

This analysis reveals that 14% of markets are either Undersupplied or Critically so. For Grade A space, this rises to 40% of markets. Regionally, when looking at Grade A space specifically, the East Midlands, North West, South West, West Midlands and Yorkshire and the Humber have no oversupplied markets – yet, in these regions only three to five markets were analysed.

LONDON CALLING

The capital in itself paints a highly diverse picture, again with major nuances by sub-market and building type.

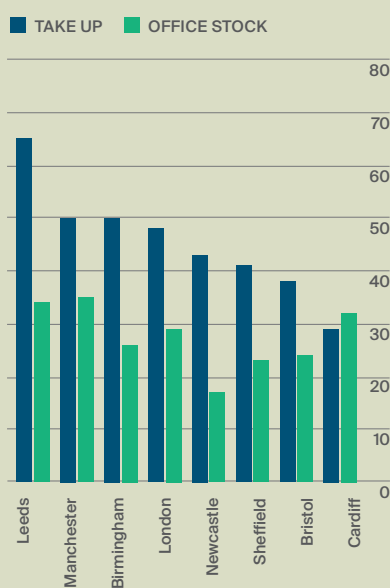
While the overall shortfall totals 4.3 million sq ft, the West End stands out as the most undersupplied sub-market, with a 4.2 million sq ft deficit. On the flip side, Docklands & Stratford is oversupplied by just over 1 million sq ft over the next three years. London’s robust construction pipeline is contributing to an 11.6 million sq ft oversupply of new and refurbished buildings, with City & Southbank ‘leading’ at 6.2 million sq ft, while Docklands & Stratford has the smallest surplus at 1.5 million sq ft.

14%

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Fig 2: Balancing act

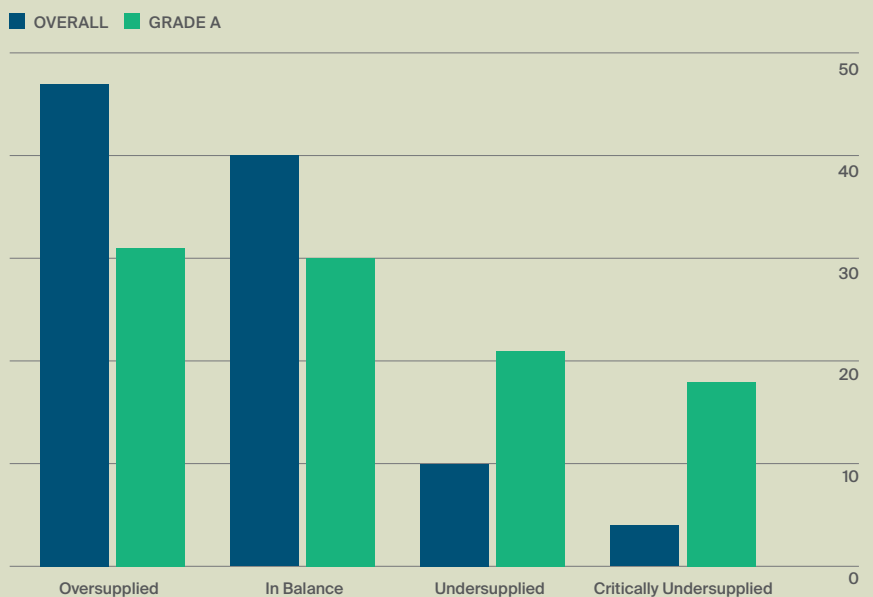
Proportion of take up and total office stock with EPC rating B or above, 2023



Source: Knight Frank Research, DLUHC

Fig 3: Working hard

Proportion of office markets in each category, analysis of more than 100 UK cities and towns, excluding London



Source: Knight Frank Research

Retail reality, hyper localisation requires a granular look for market needs

Nationally, the retail market is undeniably oversupplied. While the rise in e-commerce is often blamed, oversupply also stems from structural failings such as overdevelopment and poor management of ageing and challenged retail stock, themes explored in depth in 2018's *The Price of Change report* and revisited in *A Retail Renaissance*.

There are three fundamental questions. 1. What factors conspire(d) to create oversupply (the qual)? 2. By how much is the market oversupplied? (the quant). 3. What needs to be done to create a greater equilibrium of supply (the intervention)?

Quantifying the level of national oversupply seems relatively simple: a 15% vacancy rate would translate to about 170 million sq ft of excess retail space in the UK. However, this figure oversimplifies a highly localised issue (plus, the vacancy rate refers to number

of units, as opposed to floorspace). To assess oversupply accurately and meaningfully, we would analyse the intersection of vacancy rates, rental trends and space productivity metrics.

Even within these metrics there is a significant level of variation. Vacancy rates in 300 UK towns¹ average 18%, but extremes range from 4% to 38%. Rental performance shows even greater divergence: prime zone A rents across all 300 centres have declined by an average of -65% over the last decade, with Irvine experiencing a -233% decline, while Tooting saw rents increase by 25%.

Space productivity is arguably the most telling metric, with the least productive centres achieving spend per sq ft below £50 per sq ft. These are often centres located in the shadow of large regional shopping centres (e.g. Bicester, Rotherham and Gravesend). At the opposite end of the spectrum, the most

productive centres, such as Kingston-upon-Thames, Oxford, and Milton Keynes, exceed £500 per sq ft.

In total, 10 towns underperform on all three of these metrics. These are largely concentrated in the North of England, Scotland, and Wales, and are the most likely to be oversupplied and challenged.

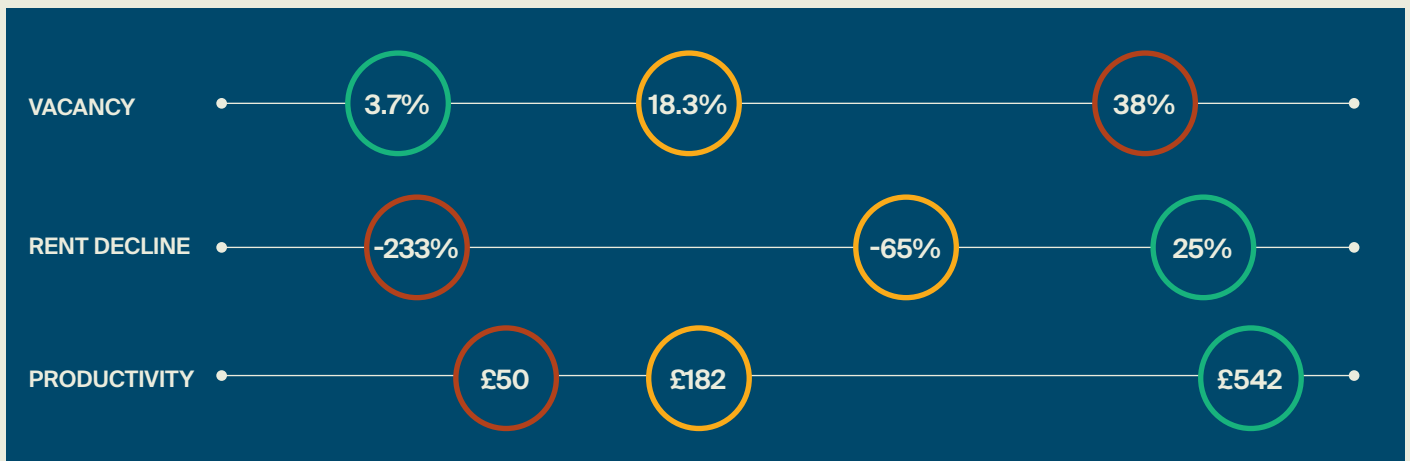
Drilling down to asset level with hyperlocal factors and assessments can be telling of how much and the type of retail required, ensuring the assets are positioned optimally.

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Table 1: Re-telling retail

Key oversupply analysis metrics across 300 UK towns and cities

Metric	Vacancy	Rent decline	Productivity (retail spend (£) per sq ft)
Average	18%	-65%	£182
Worst	38%	-233%	£50
Best	4%	25%	£542
Critical Threshold	>25%	-100%	<£100
Number of towns/cities above the critical threshold	46	64	55



¹ as defined by PMA PROMIS

Source: PMA, LDC, CACI, Knight Frank

Outlook for logistics, how the network will evolve and where to position

In total contrast to retail's metrics, there is just 20 months' worth of logistics supply currently marketed based on the last five years' average volume of take-up. Yet again, this is pocketed by region and type. For example, the largest (400,000 sq ft +) newly-built units are significantly below this average, indicating a high level of undersupply.

Typically, new stock would take some 18 months to complete, if we factor in planning and build time. However, this does not consider land availability, which may also be a constraint in bringing forward any future development. Therefore, any market which has less than 18 months of supply could be considered undersupplied.

The West and East Midlands are the most supply-constrained regions, with 22 million sq ft of available space – sufficient for only 15 to 18 months of take-up across both areas.

Scotland sits at the other end of the spectrum, with 3 million sq ft available, equivalent to 38 months of take-up. South Yorkshire, Wales, and the South West also have healthier levels, with between 2 and 3 years' worth of supply. Digging deeper and looking at newly-built units, paints a different picture. For instance, in South Yorkshire, new building stock accounts for less than one month's supply, and in Wales, no new units are currently under construction.

The complexity grows when overlaying warehouse size parameters. Availability is relatively high in the 250,000-400,000 sq ft and 50,000-100,000 sq ft size ranges, while occupiers seeking upwards of 400,000 sq ft face limited options. There is only 10 million sq ft available, equivalent to just under nine months of supply. For those requiring new or grade A buildings, the options are

further narrowed to 7 million sq ft or just six months of supply. This is less of an issue for smaller unit sizes, where availability in the 250,000-400,000 sq ft and 50,000-100,000 sq ft brackets appears plentiful with upwards of 27 months of supply.

It is worth noting however, that this analysis looks at patterns and levels of historic demand, which may not be a good indicator of future demand.

22m

The West and East Midlands are the most supply-constrained regions, with 22 million sq ft of available space – sufficient for only 15 to 18 months of take-up across both areas.

This analysis is based on data as of Q2 2024

How might this change with future occupier needs?

There is a clear structural shift in occupier demand for better quality offices, but current availability and lease events are driving the current take-up levels. Any asset strategy ultimately needs to be driven by future demand.

The functional aspect of obsolescence also covers the strategic role that real estate plays. Indeed,

94% of respondents from the (Y)OUR SPACE research saw real estate supporting, facilitating or embodying wider business strategy, not simply a box in which to place employees. Today, real estate supports a wide array of strategic intent, be that the attraction and retention of talent, increasing collaboration or innovation, or delivering against ESG commitments.

ALL ABOUT THE E

With real estate responsible for around 40% of the UK's carbon emissions, energy usage and efficiency could be pivotal to reaching net zero or carbon reduction goals.

In terms of ESG, 93% of all occupiers believe that their company's commitment to ESG influences the real estate decisions they will make over the next three years – with almost a quarter believing their ESG strategy

will influence those decisions to a great extent.

Some almost 600 UK companies have committed to the 'gold standard' of target setting, the Science Based Targets initiative (SBTi), with around 50 aiming for net-zero carbon. This is likely to accelerate following the change in government in the UK, given the Labour Party's commitment to mandating Paris-aligned transition plans for financial institutions and ambition for the UK to become the green financing capital of the world. More companies adopting transition plans and requiring disclosures will further boost demand for highly efficient space. This will be true of the offices and other real estate they occupy. A significant level of scrutiny will be applied to energy usage and efficiency, with transparency over carbon footprint and other metrics being spotlighted.

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E MEETS S

As the ESG agenda moves beyond pure environmental concerns, the growing popularity of amenity rich buildings or ones that fulfil social aspects has come to the fore. In *Meeting the Commercial Retrofit Challenge – Part 1: Defining a Decarbonisation Strategy*, we explore in depth from an office occupier perspective, what is the wish list for

amenities and what the market has been delivering.

For other sectors there are unique challenges, especially when building in social elements and strategies which can be unique to localities and type of real estate. Environmental issues tend to dominate the narrative. But, increasingly social issues have moved up the agenda. For retail, the social realm is perhaps where the sector can generate most value.

How? The sector potentially holds the key to transforming the UK’s social and economic wellbeing for two key reasons. Firstly, retail is the UK’s biggest private sector employer, providing jobs to 13% of the population. Its sheer scale means the way retailers engage with their workforce (such as providing a living wage) has a major impact on a substantial proportion of the UK’s economy.

Secondly, retail locations (i.e. high streets) are traditionally viewed as the heart of many communities, providing essential everyday goods and services. Retail property is therefore an integral part of the UK’s social fabric – so much so, that movement in vacancy rates are keenly watched as a barometer of a town’s or city’s underlying health.

40%

With real estate responsible for around 40% of the UK’s carbon emissions, energy usage and efficiency could be pivotal to reaching net zero or carbon reduction goals.

Oversupply vs obsolescence – in combination or in isolation

Oversupply and obsolescence are not one and the same, but there is often correlation between the two ‘Os’. In any geographic location, there is a hierarchy within the local real estate market, with assets ranging from bad to excellent. In an oversupplied market, this hierarchy is amplified, the worst assets falling even lower on the scale. Put simply, the worst assets in an oversupplied market have no place to hide and the risk of obsolescence is significantly heightened.

But the link between oversupply and obsolescence is not a watertight one. Stronger assets in an oversupplied market can still thrive, without any risk of obsolescence – at least in the immediate to medium term.

Whilst the risk of obsolescence may be higher in an oversupplied location, it can still happen anywhere, even in an undersupplied market. Nor are the factors that determine obsolescence entirely ESG-related. A brand new, high spec, BREEAM Outstanding building is effectively obsolete if it is vacant with no prospect of future occupation. It may tick all the ESG boxes, but is surplus to requirements if there is no occupier willing to lease the space.

Oversupply and obsolescence are complex forces in isolation, even more so in combination. Be that as it may, significant portions of the real estate market already fall into the obsolescence camp and many

more assets will join them in the years to come.

The question of what to do with challenged, stranded or obsolete assets is infinitely more complex than the issue of how they reached that state in the first place. And ultimately more important.

“Whilst the risk of obsolescence may be higher in an oversupplied location, it can still happen anywhere, even in an undersupplied market.”

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



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