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WHITE PAPER

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Repositioning UK Office Assets — Risks and Opportunities: Best-in-Class vs. Out-of-Date

Over recent years, we have seen an office sector where occupiers are taking less space and using it in a different way in the United Kingdom, even when compared to five years ago. That trend, which was accelerated by the COVID-induced home working social experiment, coupled with the significant increase in scrutiny on environmental performance from both investors and occupiers, is driving an era-defining set of market dynamics and a clear need for repositioning and reuse of a significant proportion of the existing office stock.

This *White Paper* explores the real estate, planning and construction risks and opportunities presented by those market dynamics and provides guidance on areas to be considered by investors and developers seeking to take advantage.



“Life Sciences is a building in Cambridge”. So a property veteran was quoted as saying recently in the context of a discussion on the future of offices in the United Kingdom. A pessimistic view? Perhaps. But nonetheless, investors, owners, funders and developers of office assets are faced with the challenge of what to do with buildings (whether in Cambridge or elsewhere) which are on the wrong end of a dramatic negative shift in demand for office space that is not extremely high-spec, environmentally excellent and ideally located.

The hurdles are well known: a huge increase in developers and investors applying ESG principles to their business, a looming date of 2030 for commercial buildings to meet EPC B and a flight to quality by office occupiers, who are taking less space and using it in a different way even from five years ago. All accelerated by the COVID-induced home working social experiment. Add an inflexible and unagile planning framework into the mix and it is easy to take that pessimistic view.

However, the challenges present those with expertise and, admittedly, longer-term patient capital, with opportunities to acquire assets at appropriate values and to reposition them for alternative uses, including residential, hotel and life sciences, and to receive increased returns as a result.

As ever with property investing and development, those with vision and who take a considered and informed approach will win over time. For example, one cannot expect to shift the demand/supply dynamic in the residential sector by simply turning an office in a poor location into apartments. Delivering appropriate amenity space, retail and entertainment offerings will lead to more success. Perhaps Canary Wharf and other similar locations have a head start here, even for those buildings which appear on the face of it to be more difficult to address, such as HSBC’s HQ building.

Certainly the property industry will need more flexibility and agility from the planning and construction sectors in order for those with a vision to deliver. We examine in this *White Paper* some of the legal and policy challenges, considerations and opportunities for those looking to explore this area.

PLANNING—RISK AND OPPORTUNITIES

In the United Kingdom, the Government has previously viewed the conversion of offices to homes under permitted development rights (“PDR”) as a valuable way of boosting housing supply. However, it is not always a straightforward route to repurposing an obsolete office block.

Under PDR (*Class MA*) a building with a commercial, business or service use can be changed to a dwellinghouse subject to prior approval and certain criteria and conditions being met. For PDR to apply, the following criteria must be met (in summary):

- The building must have been vacant for at least three months prior to the date of the application for prior approval;
- The previous commercial use must have been ongoing for a continuous period of at least two years prior to the date of the application for prior approval;
- The total floorspace of the existing building cannot exceed 1,500 square metres;
- The building must not be a listed building, ancient monument or in a safety hazard zone or site of specific scientific interest; and
- The building must not be located (*inter alia*) in a national park or an area of outstanding natural beauty.

In addition to the above criteria, the developer must apply to the local planning authority for determination as to whether prior approval will be required in relation to:

- Transport impacts and site access, contamination risks, flood risks and noise impacts;
- The impact of the change of use on the character of the area if in a conservation area;
- The provision of adequate natural light in all habitable rooms; and
- The impact on intended occupiers of the introduction of a residential use in an area possibly used for industrial uses.

The floorspace limit of just 1,500 square metres is particularly limiting for the conversion of larger office blocks. This contrasts with the previous office-to-residential PDR (*Class O*) which had no such floorspace limit, but was phased out in July 2021.

We also note that building regulations specify minimum space standards that must be complied with, and any external alterations to the building would require planning permission.

All of this means it can often be difficult for office buildings to be converted to residential uses through PDR. By their very nature, office buildings were not designed for residential uses. Given their physical design, it can be hard to satisfy the requisite natural light requirements and minimum unit sizes. Outdated offices typically need significant amounts spent on them to satisfy these planning and building regulation requirements as well as to meet market expectations. This raises concerns that some office buildings in the United Kingdom could become “stranded assets” if the capital expenditure required to repurpose the building undermines the investment appeal. Investors need to be aware that the assumption in favour of PDR can be disappplied. First, a condition on the existing planning permission for the site might prevent the change of use. Second, many London boroughs limit office conversions through the use of Article 4 Directions, which have the effect of withdrawing PDR. Where the Article 4 Direction relates to office-to-residential conversions, this means that deemed planning permission is no longer granted automatically, and instead a planning application would need to be made, thereby giving the local planning authority greater control over



development in that area. Typically Article 4 Directions are put in place in an attempt to protect the employment zones in the local area.

In the coming year or two, it is possible that the PDR for office-to-residential conversion may change. Between July 24, 2023, and September 25, 2023, the Government consulted on proposed changes to PDR. This consultation included questions on whether the floorspace limit should be doubled to 3,000 square metres or simply removed altogether, and whether the requirement that the premises be vacant for three continuous months should be amended or removed. The Government is reviewing the consultation responses, and the outcome is expected to be published next year, although with a general election on the near-term horizon, it remains to be seen whether reform will be brought through and whether or not an alternative government would follow the outcomes of the consultation process.



We may also see some London boroughs reassess their policies in respect of office conversions. For example, Tower Hamlets Council is considering relaxing planning rules in Canary Wharf and the City fringe to allow for office space to be repurposed. The proposals are set out in the Council's draft new local plan documents. The intention is to relax current "office only" boundaries in the borough, relax the rules around change of use and offer more flexibility related to residential development. This could be a harbinger of change in London with planning policy providing further support for office-to-residential conversions.

If the Government does relax the office-to-residential PDR criteria and conditions, and if new local plan policies are increasingly supportive of such conversions, then this could help to free up the planning process, facilitate a key area of growth in the housing market and provide a route out for those sitting on otherwise stranded assets.

CONSTRUCTION AND PROCUREMENT

Retrofitting office space—whether to convert to a different use or to upgrade to provide a more attractive offer in the post-COVID environment—has a number of well-known benefits from a construction perspective.

For the increasing number of developers focusing on how they can apply ESG principles to their business and improve their ESG credentials, the reduction in carbon emissions that can be associated with retrofitting rather than demolishing an existing building is foremost among these benefits.

Demolishing and rebuilding an existing structure involves significant carbon emissions, particularly when assessed on a "whole-life" basis, a point which was emphasized by the decision of Michael Gove, in his then role as secretary of state for levelling up, housing and communities, to refuse planning permission for the demolition and redevelopment of the Marks & Spencer Oxford Street store in London. As Gove noted in the decision (which is being appealed by M&S), "there should generally be a strong presumption in favour of repurposing and reusing buildings".

Planning considerations aside, by undertaking retrofitting projects, developers can position themselves as contributing toward the transition to net zero and appeal to investors and tenants alike whose own net-zero policies factor into the developments they opt to fund and the spaces they choose to occupy. This is part of a wider trend in real estate and construction to embrace carbon reduction by, for example, increasing specification of less carbon-intensive reusable construction materials and the adoption of "green" working practices on site. The achievement of a BREEAM "Excellent" rating or a particular Energy Performance Certificate rating, once a "nice to have", is now a critical issue for many prospective tenants.

From a legal perspective, the first point for a developer to consider when carrying out a retrofitting project is the appropriate form of contract to use. This will depend, in large part, on the nature of the works being carried out; the contractual arrangements for specialist engineering works to improve the energy efficiency of an office space will obviously differ from those for the full-scale conversion of an office to a residential use. In the latter case, the JCT Design and Build form of contract, amended by a bespoke schedule of amendments, remains a popular choice in the United Kingdom, although the key negotiation points are likely to differ in a number of respects from a new-build development.

For example, a key concern will be the allocation of risk between the developer and contractor with respect to the condition of the existing structures. Discovering latent defects in the existing structure during the course of retrofitting works can result in significant delays, spiraling costs and, in some cases, derail a project entirely. While the risk can be mitigated to an extent via surveys, the parties should nevertheless ensure the contract is clear as to who bears what time and cost risks, should an issue materialize.

A further consideration and point for negotiation is design liability. Retrofitting involves the introduction of new components to an existing structure and potentially complex interplay between the original design and the new elements. As a consequence, contractors may be less willing to take on the entire design responsibility for the works and seek project-specific carve-outs from their design liability. The challenge for a developer in such a scenario is to ensure that it has suitable recourse options in respect of all aspects of the design and construction of the building post-completion of the retrofit works.

As with any construction project, there are myriad risks that can materialize when retrofitting office space, whether the works are to upgrade an asset for its existing use or to repurpose it. All parties can benefit from a detailed consideration of the project and site-specific issues at the outset, as well as carefully drafted contracts that address the nuances of the particular development.

CONCLUSION

As we noted in the opening paragraphs, these multiple issues are here, now, and are not going away. The challenges and risks are difficult ones, but bold investors will have success in pursuing repositioning initiatives.



LAWYER CONTACTS

Anna Cartwright

London

+44.20.7039.5290

acartwright@jonesday.com

Matthew J. Peel

London

+44.20.7039.5202

mpeel@jonesday.com

Julian Bailey

London

+44.20.7039.5460

julianbailey@jonesday.com

James Pickavance

London

+44.20.7039.5492

jpickavance@jonesday.com

Kyle M. Baltes

Chicago

+1.312.269.4341

kbaltes@jonesday.com

Kirsty L. Rogerson

London

+44.20.7039.5174

krogerson@jonesday.com

John J. Crowley

London

+44.20.7039.5778

jjcrowley@jonesday.com

Ben Witherall

Singapore

+65.6233.5532

bwitherall@jonesday.com

Ronan Casey and Will Land, associates in the London Office, contributed to this White Paper.

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