

Intelligent Investment

Identifying value-add opportunities for CBD offices in a polarising market

VIEWPOINT

CBRE RESEARCH
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A value-add market for investors and asset managers

The market for central business district (CBD) offices is becoming increasingly sensitive to changing occupier needs. As a result it is moving towards a new paradigm based as much on changing physical building characteristics as on traditional investment factors, returns on competing assets and commercial sentiment. This offers both opportunities and challenges for investors and asset managers, and indeed valuers.

For investors and asset managers, this presents a choice between investing to protect or enhance an asset's market position, or selling at the risk of value loss in a fast-moving and increasingly polarised office market. Our evidence suggests the rental variance in key European CBDs offers a value-add opportunity that well-targeted CapEx strategies can address.

In addition to the cyclical challenges from higher, long-term interest rates, there is growing evidence of a flight to quality among CBD office occupiers. Buildings where critical features are absent (or too expensive to provide) are becoming more likely to be rejected by occupiers. Investors are now responding and undertaking more rigorous due diligence and review of assets under management, against these criteria.

Where owners are able to identify viable and targeted ways to improve a building's credentials and occupier appeal, they will have a unique opportunity to add value.

Growing evidence of a flight to quality among CBD office occupiers

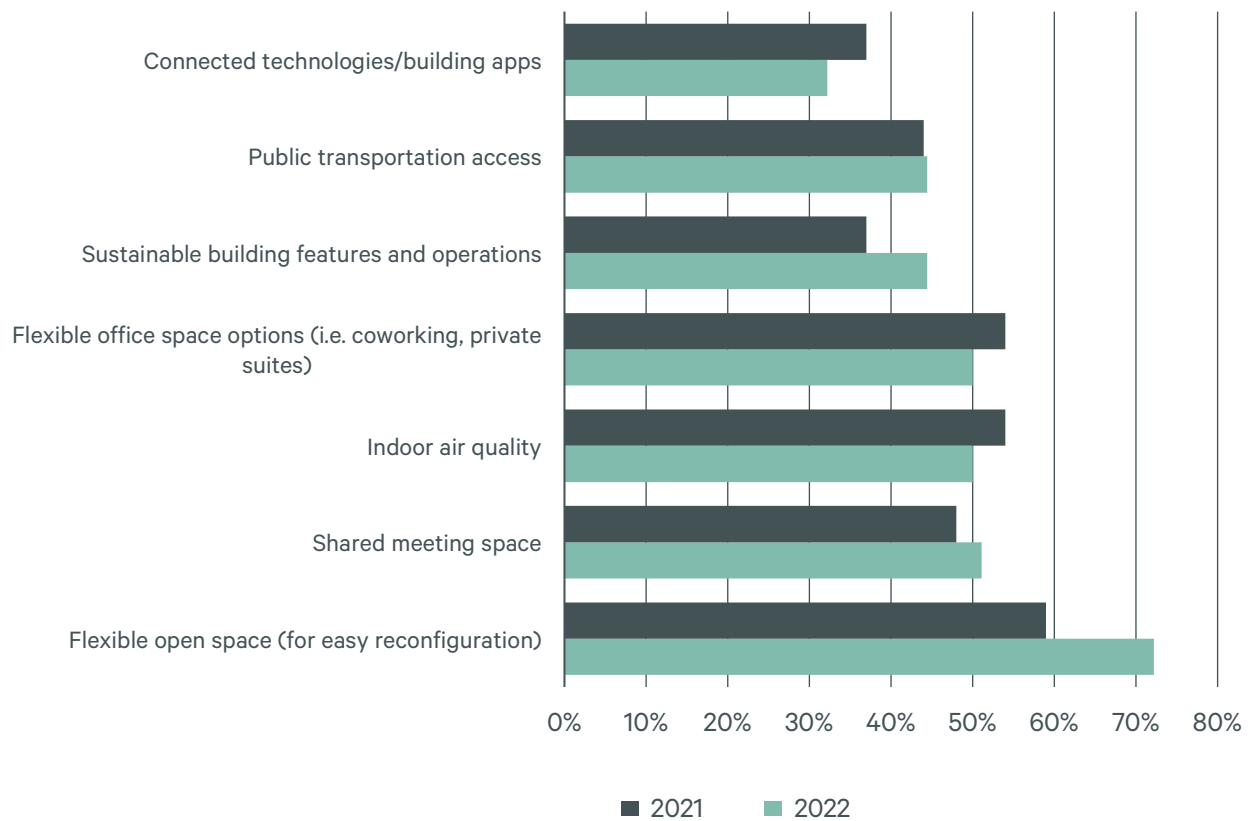
Quality

Landlords who invest to improve building credentials will have a unique opportunity to add value

Value



FIGURE 1: What will be the most in-demand building offering(s) in the future?



Source: CBRE EMEA Occupier Sentiment Survey 2022

The characteristics of occupiers' office needs appear to be changing rapidly. Companies are striving to offer working environments that support their talent objectives, and are consistent with evolving hybrid working strategies. The presence, or absence, of these features is increasingly affecting building-selection decisions, and in a growing number of cases, eliminating sub-standard buildings from consideration.

Evidence from CBRE's [Occupier Sentiment Survey](#) highlight three key factors:

- 1) Flexibility** – the ability reconfigure space quickly and easily
- 2) Sustainability features** – particularly indoor air quality but also factors such as natural light and reduced energy emission
- 3) Connected technologies** – such as user experience platforms and building apps

Flexibility features strongly in building selection alongside sustainability and layout

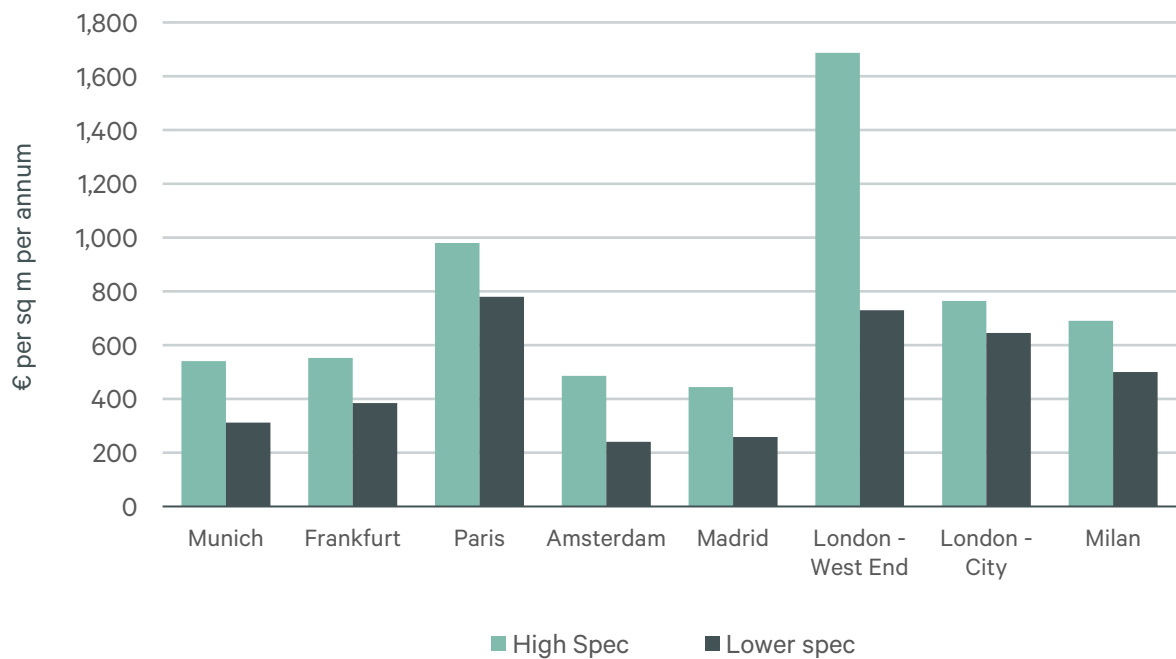
CBD office rental income ranges

Reflecting these shifts, market evidence and feedback from CBRE professionals indicate a generally widening gap between rents for the best prime buildings and those for less well-specified CBD office buildings across key European cities.

Importantly though, both the size of the differential and the mix of underlying reasons for it, vary widely across markets. This means that the scale of available value gain, and the mechanisms for achieving it, need close case-by-case analysis, depending on the city.

Across the markets we have analysed, rent differentials of over 50% is common in key European CBD office markets, between prime CBD buildings and those of inferior specification. This seemingly suggests that CapEx investment in key features will improve the rental income in the long-term. But how are investors to distribute a finite CapEx budget across different areas of expenditure to achieve maximum benefit? We explore five key features in Figure 3 and how they may vary from CBD location.

FIGURE 2: Variance in CBD office rents



Source: CBRE Research

Note: Low spec rents are indicative figures for mid-range Grade B buildings in each market. High spec rents are indicative of Grade A buildings. The CBD locations for the two specs are the same.

Five features influencing occupier popularity and value-add potential

We have developed a five-point framework for capturing the relative importance of different aspects of a building's features, under the control of the landlord and investor to add-value (See Figure 3). These features will increasingly affect tenant popularity, market positioning, liquidity – and ultimately value.

FIGURE 3: Five-point framework for added-value building features

Feature	Examples
ESG	Best-in-class carbon and bio-diversity, accreditations in LEED, WELL, BREEAM, CRREM and circular economy
Physical status	Buildings with flexibility to change structure, occupier use permits and value enhancing iconic design
Wellness	Buildings with excellent natural light, clean air, terraces and floor areas for wellness activities
Occupier Experience	Improved placemaking works and ease of occupier transition throughout the asset, occupier services available within asset including town hall, café, creche and sports
Operations	Efficiency, kit for sensors, SMART building, cyber security, power continuity, digital twins and best-in-class connected technologies

Market context

The relative importance and value-add potential of these features vary from city to city.

One key finding is that, while ESG dominates and is considered important everywhere, in other respects, the mix of factors is not uniform across all cities (See Figure 4). Owners of multi-locational portfolios need to be sufficiently flexible in their approach to asset enhancement to maximise the opportunity as shown below. We share below some insights experienced by CBRE project teams across the specific CBDs:

Amsterdam - More focus on the ESG and wellness features. The office building is a key element in competing for the best talent in this market. We have seen rents increase by 30-40% where assets have been refurbished to surpass market standards in these features.

Frankfurt/Munich - Evidence of tenants prepared to pay higher rents for the best ESG performance, on the basis they are offset by lower OpEx costs. This is unlikely to remain a differentiator as the market catches up, so we expect the debate to move to bigger office units, where it is possible to raise ceiling heights and re-shape floor layouts.

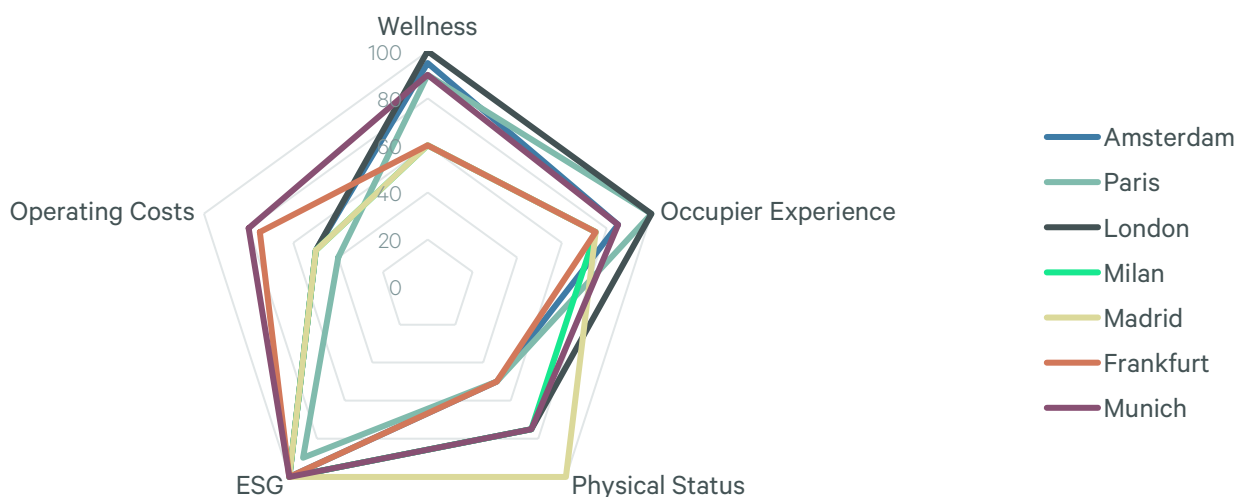
London - Similar to Amsterdam, the need to attract key resource talent and also to increase the office days versus home days working ratio is driving a greater need for wellness and occupier amenities and facilities. Best-in-class ESG is the standard in London.

Madrid - In some cases, there are rental variances of up to 20% for the best ESG performance. However, the opportunity to refresh assets is often limited due to the low free heights of offices built in the 1970s. Therefore the age of the asset becomes critical in assessing the flexibility to add-value through CapEx investment.

Milan - Having the best ESG performance is viewed as a key rental income differentiator. Similar to Madrid, there are building limitations for value-add due to planning and physical constraints. Where possible, landlords are investing in terraces, courtyards and smarter controlled buildings.

Paris - The controlled supply and high demand for CBD office space has meant that landlords are less incentivised to carry out major renovations to create the best prime CBD office. Much CapEx is limited to ESG improvements and end of lease refresh works covering lobby, lifts and MEP upgrades.

FIGURE 4: Distribution of importance of different value-adding characteristics



Source: CBRE Research

Strategies for investment

It is evident that growing rent differentials are creating an opportunity for landlords to review, improve and, in some cases, reposition assets. Costs will be critical to ROI analyses. We identify three levels of CapEx investment, addressing the above features, to be considered for rental growth opportunities. The range of CapEx budgets for each strategy are summarised in Appendix 1.

Strategy 1:

ESG CapEx - Required to avoid becoming stranded and facing rent income reduction

A key solution is for the traditional chiller and boiler combination to be replaced with air source heat pumps. Air handling units are another consideration in order to manage greater demand for amenities to differentiate an office from home i.e. catering provision and gyms. Other measures include upgrades to the building management system and secondary installation such as LED lighting and fan coil units to cut energy usage, monitor occupancy levels, ramp-up/ draw-down services provision to run the building efficiently during reduced occupancy.

Strategy 2:

Polish and refresh - Required to maintain asset without market risk of rental polarisation

This applies to many supply-constrained markets with few alternatives for tenants to move. ESG works are included as standard. A lower CapEx budget covers asset depreciation focused on MEP central plant replacement. Higher CapEx includes amending sizes of risers, providing sufficient tenant plant areas to allow for easier fit out, adding more breakout areas, expanded food and beverage facilities. The end result will reduce the density of occupation and the net/gross ratio. For the external envelope, cosmetic non-structural, upgrade of the façade is considered.

Strategy 3:

Reposition asset via major refurbishment

This represents a more substantial reconfiguration of an asset, targeting higher rents. Typically, such projects would be based on an in depth analysis of end user needs, such that the asset itself and the workspace environment becomes a differentiator to the occupier's business. The focus is primarily on wellness, including creating dedicated spaces and maximising use of external open terraces. Best-in-class ESG is non-negotiable with new refreshed plant kit. Specific interventions will depend heavily on the age and condition of the building, but likely to include structural alterations, changing slab heights to improve natural light or increase net floor areas. Full replacement or significant remedial improvements to the façade will be a high possibility for the higher CapEx budgets.

Strategy CapEx example ranges

Amsterdam

CapEx Strategy 3

£200 to £500 per sq ft

Frankfurt

CapEx Strategy 2

£100 to £250 per sq ft

London

CapEx Strategy 1

£50 to £80 per sq ft

Madrid

CapEx Strategy 2

£72 to £180 per sq ft

Milan

CapEx Strategy 2

£76 to £190 per sq ft

Paris

CapEx Strategy 2

£92 to £230 per sq ft

Summary

There is an evolving shift in occupiers' preferences towards buildings that offer high amenity and user experience features. These preferences extend well beyond ESG priorities. The consequent polarisation in CBD office markets, and in rental values for buildings of different quality, presents opportunities for owners to direct CapEx towards areas most likely to enhance or protect value.

Widening rental differentials across this quality spectrum are evident in key European office markets. The process of asset valuation is becoming increasingly sensitive to the scale of these technical and asset performance differences and the underlying reasons for them. Since owners and investors need to respond to the market and take account of occupiers' changing needs, valuers do too – the process is changing as a result. More and better data is needed to inform these assessments and produce greater precision. So far, the focus of this shift has been the widening of rental differentials between the best buildings and others. But we would expect systematic differences in the occupier-appeal of different buildings to generate wider cap rate differences over time as well.

The three key takeaways for owners and value-add investors looking to take advantage of this evolution are:

- 1) The scale of rental differences and the reasons for them are not uniform across all markets. There is an incentive to undertake detailed ROI analysis on an asset by asset basis for value-add opportunities and understand future valuation positioning
- 2) There are different strategies available to owners and value-add investors, to take advantage of these opportunities. We propose a five-point framework to consider asset features to differentiate against, and three strategies of CapEx works that deliver the required asset improvement
- 3) ESG positioning is a recurring and fundamental issue that is a value driver to be addressed across all the main European office markets

Since occupiers are also continuing to work through the implications of hybrid working for them, their requirements will be dynamic. This requires investors and owners to track and monitor trends very closely and acknowledge that traditional approaches may need to change.

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Appendix 1 – Indicative CapEx Costs

FIGURE 5 : Indicative CapEx costs (£ per sq ft) as at April 2023

Costs expressed as £/sqft (multiple by 12.27 for €/sqm on £/€ exchange rate of 1:1.14)

	London		Frankfurt		Munich		Madrid		Amsterdam		Paris		Milan	
	Low	High	Low	High	Low	High	Low	High	Low	High	Low	High	Low	High
Strategy 1	40.00	80.00	50.00	100.00	52.50	105.00	36.00	72.00	40.00	80.00	46.00	92.00	38.00	76.00
Strategy 2	80.00	200.00	100.00	250.00	105.00	262.50	72.00	180.00	80.00	200.00	92.00	230.00	76.00	190.00
Strategy 3	200.00	500.00	250.00	625.00	262.50	656.25	180.00	450.00	200.00	500.00	230.00	575.00	190.00	475.00

Source: CBRE PJM

The above are benchmark costs only, inclusive of overheads & prelims but excluding tax. Each project's budget is shaped around target rent specification and investor business plan.

