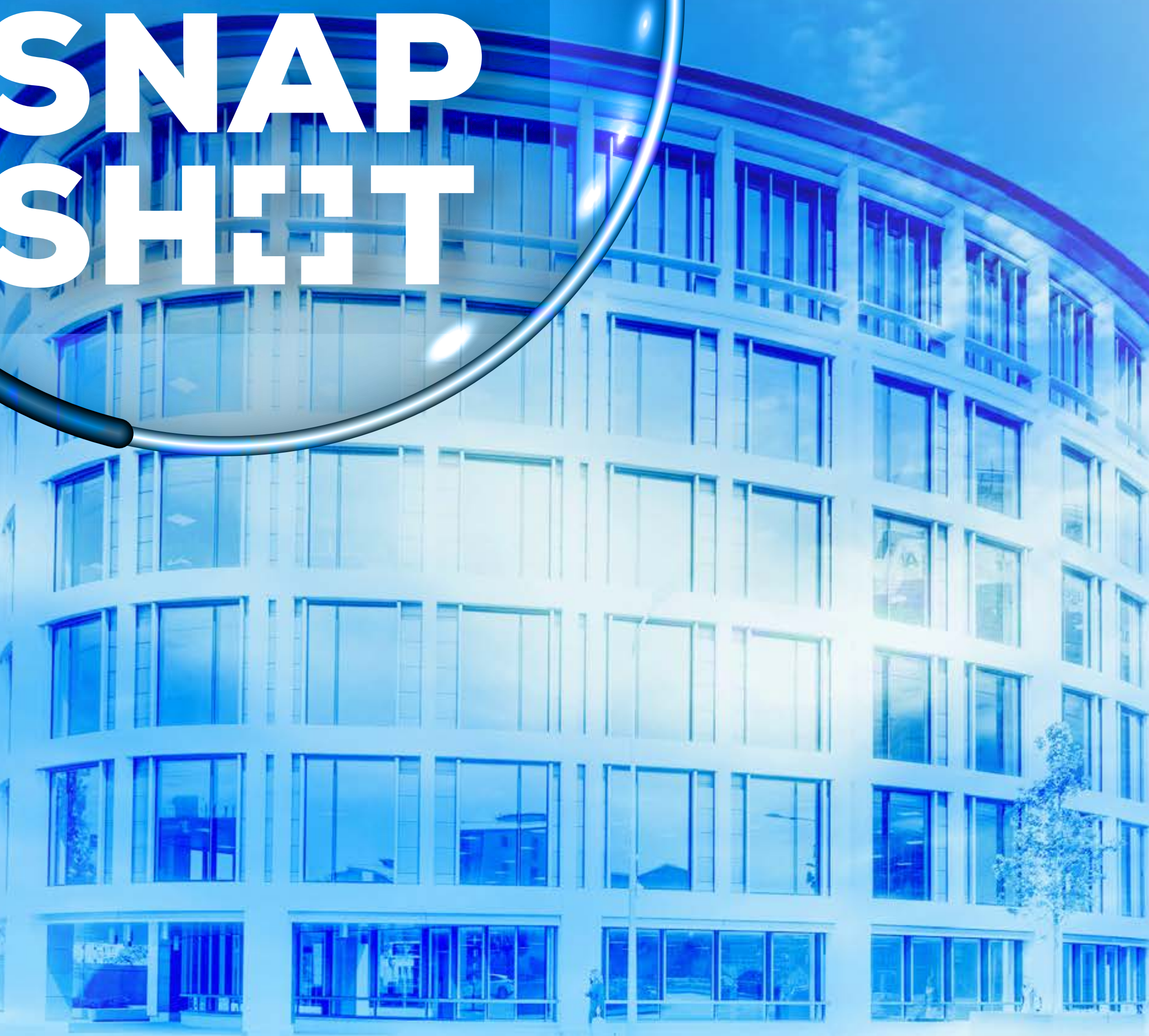
June 2020

The Channel Islands' Commercial Office Market

SNAP SHOT



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The Channel Islands & the Impact of Covid 19

In 2018 we had record take up in the office market and in 2019 record levels of investment activity. At the start of the year we were predicting a higher level of take up in Guernsey and Jersey but a quieter year on the investment front. The unprecedented and tragic impact of the global Coronavirus pandemic has, not surprisingly, forced a change in our outlook for 2020 & 2021.

Looking at the UK, the impact on the market has been significant. The latest reporting from Property Data is suggesting a potential 'year on year' fall in UK regional office investment volumes of over 85% from May 2020 compared to May 2019 (provisional) and investors now have the tricky task of trying to assess when the market might recover and ensure they are in a strong position to capitalise on any opportunities. So, against this backdrop, how are the Channel Islands fairing?

A potential year on year fall in UK regional office investment volumes of over 85% from May 2020 compared to May 2019

INVESTMENT MARKET UPDATE

Investment volumes reached record levels across both Islands in 2019 so there is no shortage of comparable evidence pre Covid. However, since the Covid 19 outbreak the market has obviously changed significantly, with the majority of live transactions rapidly grinding to a halt. With little transactional data since Covid, we are also having to look at the trends developing in the UK to assess the yield shift.

Market sentiment in the UK seems to suggest yields have moved out between 25 bps - 50 bps during the pandemic, albeit, as stated above the scarcity of deals means this is in part based on anecdotal evidence.

In terms of hard evidence locally, there is very little. However, D2 Real Estate agreed terms to sell a good quality office investment before the Covid outbreak. The property is let on a 15 year lease to a tenant of good covenant strength, but perhaps not top tier. The valuation has been adjusted by around 35 bps and the price adjusted accordingly, so in line with the UK. There is still some way to go in terms of the transaction reaching completion, but if it proceeds, then it will provide a good indicator of the impact.

It is important to appreciate the impact of covenant strength in this situation. Looking back at the last financial crisis in 2008 those assets with defensive qualities, ie prime location, long leases and let to 'Blue Chip' covenants, held their value. This time around it is no different and in some cases we have actually seen yields harden!

In contrast, investments with occupational risk, particularly in secondary locations, require a degree of caution. However, the impact on secondary market will in part be determined by the alternative use value, which is so crucial, and it appears the residential market is still holding up very well, so each asset needs to be assessed on its merits and with expert knowledge.

We have seen a lot of investment enquiries for assets with defensive qualities, so there is definitely confidence in the local market and willingness to buy. We are therefore working on a number of "off market" opportunities ranging from £3m to £50m, which is in part down to the Islands' "safe haven" status, particularly as both islands have dealt with the virus well.

However, the biggest hurdle we have faced is trying to progress with initial due diligence, particularly inspections. It is all well and good that the respective Governments are allowing inspections to take place, but its practical effect is limited if occupiers simply won't allow you into their premises or investors cannot travel to the Islands to inspect properties.

In terms of bank lending, it seems there was an initial pause to "take stock" from some banks, however this seems to be relaxing, although due to the issues of inspecting premises we expect most of the activity to take place in the latter part of the year.

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Traditionally the banks in the Channel Islands have been very supportive to investors and any foreclosures tended to be a result of wider issues in their client's business or lost causes, and as a result these have been rare. Therefore, we do not expect there to be a raft of forced sellers resulting from bank pressure, particularly as loan to value covenants have remained relatively low and there isn't an abundance of stock sitting vacant.

Key Points

- In general a potential yield shift of between 25 and 50 bps, but this is very sensitive to lease length and covenant strength and it appears yields for the very best assets, let to Blue Chip covenants, are actually hardening.
- There are a number of live enquiries for assets with defensive qualities. The Channel Islands are very well placed to provide stable returns, so we expect this to continue, particularly in light of how each Island has coped so well with the pandemic.
- For "value add" opportunities there is obviously more risk. We accept we are at the early stages of significant economic downturn in the UK, the repercussions of which may well be felt in the property market for some time to come. Expert local market knowledge is therefore crucial.
- Completing due diligence, particularly inspections, is resulting in significant delays.
- With low LTV's and the banks being generally supportive, there are unlikely to be many forced sellers.

> *We are in the early phase of a possible office market evolution and there will no doubt be some winners and losers*

OCCUPATIONAL MARKET UPDATE

Obviously there has been much discussion about what might happen to the office market long term and thankfully this didn't take place 5 years ago when we suspect the IT technology would be found wanting! What is apparent is that the Covid 19 situation has simply accelerated occupiers' digital strategies and it seems as though this has, on the whole, been successful, albeit whether success is measured by increased productivity or ability to actually work remotely, remains to be seen.

As we manage a significant commercial property portfolio, we have held regular calls with our occupiers, many of whom have a global presence. From these calls we have compiled a list of some of the key points that are now filtering through, so we can try and gauge occupier sentiment.

Results from Occupiers Survey

- In the short term, no large increase in staff numbers is expected back in the office regardless of the Government permitting them to do so. Any return to office will be phased and it is probable that many companies will operate with split teams and reduced occupancy to achieve social distancing and from a business continuity point of view.
- We get the impression that despite all occupiers saying homeworking is going well they are measuring that on whether it has been possible (e.g. laptops issued, staff having connectivity, desks and chairs sent to staff), rather than productivity, which is difficult to measure just now. It seems that over the next few months staff productivity will become a key measure. Homeworking as a default option will be present for sometime to come, but there are obstacles for businesses, such as ensuring that staff have the space to create a compliant, safe working environment.
- It is significantly more difficult to train junior staff remotely, it makes staff management far more intensive, staff are concerned about not being in their managers "vision" when considering promotions and it is far more difficult to establish a work culture.
- From a staff perspective, our occupiers' surveys suggest the key concern about a return to the office is the commute to work on public transport. This is likely to lead to regional variances, such as stronger resistance to returning to work in London compared with the Channel Islands. The secondary concern is shared space within the offices, which is likely to result in less "hot desking" and touchpoints. What is also clear is that staff are missing the social interaction, which in many businesses is fundamental.

Future Office Demand

We expect there will always be a need for office space, the question is how occupiers will use it. This is a fast moving situation, however our observations and current impact can be summarised as follows:

1. Throughout the Channel Islands several large relocations have been delayed or fallen through. Occupiers are now going through the process of evaluating their occupational needs knowing that some staff can work from home. This has resulted in several occupiers re-gearing their lease and this trend seems to be building momentum. We have not seen any impact on rental levels to date, as there is not an abundance of choice or empty office space available.

2. The environmental credentials of offices have been a theme for some time now and we have no doubt the resilience of a building to another pandemic will also be considered in detail by major corporates. Buildings without touchpoints and other control measures should be considered by developers if their target market is corporate occupiers with a global presence. This obviously will come at a cost, so although occupiers may require less space, rents may have to rise. In contrast, some occupiers may actually require more space to ensure that any future social distancing can be adhered to, but this is likely to be short term.

3. Buildings offering flexibility are likely to attract occupiers as their size requirements may well change over time. Serviced office operators will no doubt adapt, as shared work areas may be considered a risk. However, the flexible lease structure which will enable tenants to cease occupation at little cost on short notice will appeal to some occupiers.

4. Working from home works to an extent, however a lot depends on the nature of the work and more importantly if the employee has adequate facilities and space at home to work efficiently, and not forgetting the long term extra cost (wear and tear, broadband, consumables, IT etc) which employees will ultimately bear. In the Channel Islands commuting is not a major cost or inconvenience relative to the UK, so the attractions of working from home are of less benefit.

5. People are sociable and work best when they collaborate together. The best ideas often evolve through a "throw away" comment in the office. Some tasks can be completed more efficiently outside the office, so it very much depends on the specific role of the personnel, so a more flexible working approach will no doubt evolve with all occupiers.

6. For marketing purposes we have always recognised the importance of technology and were the first commercial agent to use virtual tours to market commercial premises in the Channel Islands. We know the virtual tour "hit rates" for some major UK consultancies have increased by 90% since the lockdown. Developing the personal relationship with potential occupiers and knowing the market and product is still the most important marketing tool, but certainly virtual tours will help if access is denied in the future.

CONCLUSION

In summary we are in the early phase of a possible office market evolution and there will no doubt be some winners and losers. If you take London as the epicentre where we do expect some change, then the Channel Islands are very much on the periphery. Both Islands have been very successful in dealing with the pandemic even though they have taken different approaches, and it demonstrates the benefit of living on an Island where you can control movement effectively. We also do not have the long commutes and reliance on public transport and the car is still by far and away the most popular mode of transport, again this will mitigate risk and put us at an advantage.

Jersey and Guernsey are currently making positive strides to relax lockdown restrictions and we see this as a real opportunity for the Channel Islands that hopefully will attract new investment. Businesses will no doubt adapt in time and a flexible approach will be adopted, but we certainly don't see this being the end of the office market, it will simply evolve as it always has done, as fundamentally humans are sociable and work best as a team.

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