Pre-Letting of Office Developments

Introduction

‘Pre-letting’ is an agreement between a potential tenant and a developer to lease a building whose construction has not yet started. Benefits typically flow to both parties from a pre-letting, however, opportunities to pre-let are limited by place, time, market forces and the negotiation strength of both parties.

This research bulletin, which has been produced jointly with Northumbria University, involved interviewing 30 office occupiers and developers who have been involved in pre-let agreements throughout the UK. It examines the pros and cons of taking a pre-let, the typical lease terms, and design issues. It also looks at where and when pre-lettings are most likely to occur.

Key Issues

Why do occupiers take pre-lets?

Our interviews identified four key reasons why corporate occupiers take office leases prior to development. These are:

- When they have exhausted the search for suitable, modern, available office stock in their search area.
- To achieve financial benefits such as rent-free periods, cash incentives, discounted rent, discounted or free fit-out costs etc. We examine this area in more detail later in the bulletin.
- To create a bespoke building, tailor-made to their business requirements (layout, specification, size, facilities, branding etc). We examine design and fit-out issues in more detail later in the bulletin.
- The Chief Executives of some large companies have a major influence on the decision to pre-let a building and occasionally, a very powerful CEO may be determined to pre-let a prestigious, bespoke, new building, despite potentially suitable stock being available.

An occupier will usually consider taking a pre-let either due to a major lease expiry or a break in an existing lease. In some cases, however, when the occupier does not have a lease expiry or break in the near future, a developer may choose to buy the freehold of the tenant’s existing building and allow the occupier’s lease to be surrendered in order to facilitate the pre-let. Other developers may chose to take an assignment of the tenant’s existing lease to free up the tenant to sign a pre-let.

What are the potential risks to the occupier?

Our interviews identified several potential risks that an occupier should be aware of when taking a pre-let:

- The potential occupier will generally have a lease end or other date to meet and will have to commit to a scheme that is still on the drawing board where precise timing may be uncertain. Therefore, creating trust between the potential occupier and the developer is essential.
- It is harder for the occupier to visualise the new development in advance of construction.
- Difficulties can arise if a pre-let building is so bespoke that it is more difficult to sub-let surplus space. In addition, if a decision has been taken to brand the building (externally or in the entrance hall), this can also cause issues with potential sub-letting as a branded building, not surprisingly, is very much associated with one particular company.
- The occupier may be tied to the property for a longer time period due to its bespoke nature (often a minimum lease length of 20 years with no breaks). Consequently, this reduces flexibility and can place a large, long-term financial burden on the company.

Bishops Square, London EC1. Allen & Overy pre-let 150,000 sq ft. GVA Second London Wall acted
What type of occupiers might benefit most from taking a pre-let?

Although pre-letting of office space is not solely undertaken by larger companies, larger organisations gain the greatest benefits due to their greater bargaining power. This enhanced power comes from their:

- covenant strength – a developer is likely to offer greater incentives to a strong tenant. Where the viability of a scheme is marginal, due to location, market forces or timing, pre-letting to a tenant with a strong covenant is particularly advantageous to the developer.

- company image – these larger, more prestigious companies are the key tenants that developers are looking to sign up, especially if they comprise the first letting at the scheme (anchor tenant) as it sends out a strong positive signal to the market and is likely to attract other tenants to subsequent phases of the scheme.

- willingness and ability to forward commit – as smaller occupiers generally do not plan their property requirements years ahead, and their bargaining powers are quite limited, pre-letting is generally not a common phenomenon at this end of the market.

There are also benefits and drawbacks to the developer of entering into a pre-letting agreement. The potential benefits and drawbacks to both parties are summarised as follows:

### Potential Benefits

<table>
<thead>
<tr>
<th>Occupier</th>
<th>Developer</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Provides space where a suitable speculative building is not available</td>
<td>• Risk reduction</td>
</tr>
<tr>
<td>• Lower rent &amp; better financial terms</td>
<td>• Improved covenant strength and higher capital value</td>
</tr>
<tr>
<td>• Lower fit-out costs &amp; less waste</td>
<td>• Easier and cheaper bank finance</td>
</tr>
<tr>
<td>• More influence over design and specification</td>
<td>• Kick starts large schemes</td>
</tr>
<tr>
<td></td>
<td>• Facilitates forward sales to investors</td>
</tr>
</tbody>
</table>

### Potential Drawbacks

<table>
<thead>
<tr>
<th>Occupier</th>
<th>Developer</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Risk of the building not being delivered on time</td>
<td>• May produce lower profit</td>
</tr>
<tr>
<td>• Risk that the building will not meet expectations</td>
<td>• Cannot take advantage of rising rental values during construction</td>
</tr>
<tr>
<td>• Difficulty in sub-letting if the building is too ‘bespoke’</td>
<td></td>
</tr>
<tr>
<td>• Longer lease commitment</td>
<td></td>
</tr>
</tbody>
</table>

What might attract an occupier to a particular scheme?

If the potential pre-let is on a phased development, and one or more of the earlier phases is already complete, this will help prove to the potential tenant that their building is deliverable and it will also give them an idea of building quality and appearance etc.

Where development has not yet commenced and timing is more uncertain, a cleared site is better than a site where existing buildings are still standing, as demolition reduces the time horizon of the development, often by over six months, as well as removing some of the risk for the occupier as many uncertainties have already been dealt with (e.g. restrictive covenants, archaeology, services and site condition). In some cases, much of the infrastructure may be in place thus further reducing the development timescale. The speed of building deliverability is often a key consideration for the occupier. Therefore, it is essential for the developer to clear the site to put it onto a tenant’s shortlist and aid the pre-letting.

CGI graphics, websites, and other visual representations are highly beneficial in helping potential tenants visualise their building and, for larger schemes, help show the overall environmental setting of their property in relation to the whole site, although it is difficult to say whether they can help to secure a pre-let. In contrast, some developers and agents feel there is a danger that web sites reduce the opportunity for face-to-face selling with a potential tenant.
Lease terms – the pros and cons

Lease lengths
Lease lengths vary with the strength of the market, the size of development and the location. They must also balance the needs of the tenant for flexibility with the needs of the developer for a lease long enough to produce sufficient investment value. Many pre-lets involve longer leases than the market norm as they often reflect larger buildings let to larger companies who can plan ahead more easily and have the financial strength to take on a longer lease. 20-year leases for pre-lets have not been uncommon in recent years, and no developer interviewed would consider a pre-let for a lease shorter than 10 years.

Leases may have break clauses but this is unlikely to make the effective lease shorter than 10-15 years in length. It is not uncommon for the prospective tenant to agree to a longer lease than might be ideal in return for a lower rent, or longer rent free periods or extra fit-out costs, to obtain a building more suited to their requirements.

Rent reviews
Rent reviews are invariably five yearly from the date of possession, even though occupation will not occur until the fit-out has been completed. This means that if rents are agreed prior to construction starting (a true pre-let) the first rent review may not occur until 7+ years have occurred from the initial rent being agreed (assuming a two year or longer building period). In a rising market, this is clearly at the tenant’s advantage and a disadvantage to the developer (but this disadvantage may well be offset by other advantages). As most pre-lets usually occur, by definition, when the market is not particularly strong and development risks are high, this is a disadvantage that the developer has to accept. When the occupational market is stronger and availability is low, the need by the developer for a pre-let will be less and the tenant’s options will be reduced. In those circumstances a rent review at the date of possession or occupation may be possible, which would obviously enhance the developer’s capital value.

Rent free periods and capital premiums
Many pre-let agreements involve lengthy rent free periods or up-front capital premiums in exchange for significantly reducing the development risk. However, the length of rent free periods will depend on many factors as they are part of the negotiated overall financial package. Often a developer will be amenable to granting a longer rent free period because the time taken to secure a letting after completion of construction will be eliminated. Another relevant consideration is the size of development and its location. If the scheme is large and is in a non-core location, the development risks are greater, particularly for the early phases. It is not uncommon in these situations for extensive rent-free periods to be granted running to many years.

An early pre-letting of the initial phase of a large scheme in an untried location to a good covenant can be critical in kick starting subsequent phases and if a lengthy rent free period helps to secure this, it can be a price worth paying. There is often considered to be a slight discount to the going market rent in return for a pre-let although it is hard to generalise. But as in everything else the level of rent is merely one aspect of the financial terms and in some situations there is no discount to the typical market rent and in other situations the rent might even be higher if other terms are more favourable to the tenant. The developer will try to keep the headline rent as high as possible as that will affect the investment value and sale price if the development is traded on.

Market transparency
By definition in a pre-let, due to market conditions at the time or the location of the development, comparable market evidence may be difficult or impossible to obtain, so it is often difficult to state that a pre-let will involve a rental discount. In other situations encountered in our interviews a joint venture or open book approach has been adopted by developers in return for securing a pre-let, particularly if the occupational market was weak when the pre-let was negotiated.

Joint Ventures
In some situations where a developer and occupier are well known to each other, the occupier may approach the developer to look for a suitable site and in return agreeing to enter into a pre-let on a J.V. arrangement. This means that on completion and its sale or valuation, the tenant may participate in any capital value uplift, if part caused by the pre-let itself and/or general improvement in the (occupational and/or investment) market.

In other situations the tenant may agree a higher rent in return for a capital sum or agreement for higher fit-out costs, i.e. converting a capital sum into its rental value equivalent which may be cheaper than the cost of conventional borrowing. There are also examples of ‘finance leases’ as pre-lets, where fixed uplifts in rent or indexed rents are agreed at certain intervals, rather than open market rent reviews. This can help tenants in their cost planning.
The ability to influence design

What do occupiers want?

Occupiers are becoming more sophisticated in terms of how they use their space, and more aware of the cost to their businesses of office space. They require space that is efficient and flexible, and increasingly require buildings that are environmentally friendly. Developers obviously aim to construct buildings that tenants want to occupy, and the more successful they are at this, the less bespoke changes (which can be costly) an occupier is likely to require. Of course, different occupiers have different requirements. Whilst many like open plan interiors, some (for example many legal firms) still like cellular offices, and financial institutions may require trading floors. It is therefore important that buildings are designed for flexibility.

How much influence can occupiers have?

Pre-let tenants can, and often will, influence design. However, whilst occupiers often want some input into the design of a building, any design changes must still leave the building as an institutionally acceptable mainstream investment property. Developers and tenants must bear in mind how easily the building could be re-let if the tenant vacated (tenant covenant and lease length may also be factors). The layout and design must therefore be a compromise between the needs of developers and those of occupiers (although in practise many of these may be aligned).

The amount of flexibility that an occupier has to change the design is a function of several factors and will form part of the overall negotiation process. However, the most important of these is likely to be the stage of development at which the occupier enters the process. The more fundamental the changes required, the earlier in the process these need to be agreed. After the start of construction, the extent to which an occupier can influence the design is obviously greatly reduced. If a significant change is required, then the tenant may have to undertake the work after completion. If tenants want changes during construction, they need to understand that this will be at their cost, and will affect delivery timetables.

Cost implications

Developers are sometimes able to save costs by cutting out items that the tenant does not require. Pre-letting can eliminate wastage, as there is little point in fitting out a building to Category A standard for a tenant to replace it with something completely different. It is therefore better for the developer to give the tenant a capital contribution towards the fit-out cost. If the occupier has non-standard fitting out requirements, the lease may stipulate reinstatement of original design at the end of the lease to maximise the ability to re-let. For a ‘trader’ developer requiring an early sale, this is important as it helps to ensure that the investment being sold is as attractive as possible to a potential purchaser. However, in practice this reinstatement may never occur, as design criteria may be very different by the end of the lease in say 20 years time and a major refurbishment will often then be necessary. Alternatively, the financial terms of the deal could be sufficiently good to offset this potential cost.

Our interviews revealed the following examples of major changes to the design that occupiers have achieved:

- External design
- Adding client dining rooms, staff restaurants, auditorium, gymnasium
- Lift arrangements
Where and when are pre-lettings most likely to happen?

Locational trends

Developers often face real uncertainty since the office letting market has historically proved to be volatile and difficult to predict, particularly in London, by far the largest office market in the UK. Letting is the greatest concern for a speculative office developer, and where occupier demand is uncertain, developments would clearly not begin without a pre-let. The reverse side of this is that whilst it reduces risk, it will probably also lower profit.

Whilst in London and the South East pre-letting takes place within a well understood market cycle, this is not the case elsewhere. In recent years the office markets in most regional capital cities have been stable without pronounced peaks and troughs, as the chart shows.

Even large cities such as Manchester and Leeds often have a relatively low average annual take-up and a small supply of Grade A space available. In these circumstances potential tenants have more market power and developers are forced to be more cautious. It is common for a tenant’s search exercise to become quite formal and competitive between landlords and developers. In smaller or more peripheral cities, such as Nottingham or Liverpool, pre-lets are more necessary since there is insufficient or erratic take-up and lower rental values. The small size of the regional office markets, relative to London, is clearly shown in the pie chart.

Much office demand is currently focussed on city centres where developers can feel more confident when starting a speculative scheme. However, on the fringe of city centres, in secondary or regeneration areas, demand is less established and developers are more cautious. In such areas pre-lets are prized not just for themselves but because they can kick-start a larger project and create momentum. Spinningfields in Manchester is a good example. Such locations often have large multi-phase or mixed-use sites with high initial risk where pre-lets are needed, as demand is uncertain at least in the early stages. Such sites can also prove attractive to larger occupiers as they can provide the larger floorplates often required.

Nottingham or Liverpool, pre-lets are more necessary since there is insufficient or erratic take-up and lower rental values. The small size of the regional office markets, relative to London, is clearly shown in the pie chart.

Much office demand is currently focussed on city centres where developers can feel more confident when starting a speculative scheme. However, on the fringe of city centres, in secondary or regeneration areas, demand is less established and developers are more cautious. In such areas pre-lets are prized not just for themselves but because they can kick-start a larger project and create momentum. Spinningfields in Manchester is a good example. Such locations often have large multi-phase or mixed-use sites with high initial risk where pre-lets are needed, as demand is uncertain at least in the early stages. Such sites can also prove attractive to larger occupiers as they can provide the larger floorplates often required.
Pre-Letting of Office Developments

In out-of-centre locations on business parks, developers often build a first phase speculatively since, without any demonstrable product, pre-letting is not usually an option. On later phases pre-lets have been quite common since the land supply can provide for large requirements, often for call centres, and speculative building is often too risky.

Enterprise Zones have attracted pre-lets from occupiers who knew that they would benefit from 10 years free of business rates and also appreciated the extra value of a letting that unlocked capital allowances for the investor and profit for the developer. Pre-lets also occur in small towns where local employers need space the market cannot provide.

Project phasing

With a large multi-phase project, an early pre-letting is important to establish the scheme’s credentials as a business location. A sizable early letting to a blue-chip covenant will help to market the site and stimulate occupier interest in the later phases. After a first pre-let, a developer will have less risk, more flexibility and finance, and may bring forward speculative space in the same building or buildings developed subsequently. Developers seek to balance the ratio of pre-let to speculative space at any one time, either for the current phase(s) of a large project and/or for the company as a whole; thus a pre-let can lead to more development and earlier completion of large schemes.

A partial pre-let of a building may be enough to allow construction to go ahead and on large projects a developer may need to agree more than one partial pre-let. However, too small a pre-let (e.g. 25% of total floorspace) might make the remaining space less suitable to the local market, without yielding appreciable benefits for the developer, and where a scheme is at or close to viability for speculative building, the developer may not wish to pre-let a small portion. Developers seeking to attract a pre-let normally let from the top floor down, though they will not normally let the top storey alone.

The Property Cycle

A developer will normally accept a 100% pre-letting to a good covenant, unless the market is very strong, with rents expected to increase significantly, but then it should be possible to insert a rent review to take effect on the date of occupation. Nevertheless, some developers who have a bullish view of rental trends and expect a shortage of space to occur in the market, may positively decide to defer letting. A developer may expect to get a higher rent when the building is nearing completion and want to control that letting, rather than rely on a rent review that is subject to arbitration. Similarly the developer may feel that yields are likely to fall during the construction period. If it is confident of letting and of achieving rental and/or capital growth then an early letting, rather than rely on a rent review that is subject to arbitration. Similarly the developer may feel that yields are likely to fall during the construction period. If it is confident of letting and of achieving rental and/or capital growth then an early letting is less desirable.

The property cycle can, therefore, be an important consideration for developers when considering pre-letting.

Where there is an identifiable office property cycle, the extent of pre-letting varies with it.

1. At the bottom of the cycle risks are too high for speculative development and occupiers have a good choice of newly built space at lower rents, but if an occupier requires brand new space in advance of requirements it either has to pre-let or procure a freehold building.

2. As economic growth stimulates more occupier demand, developers want to respond, but the risk of speculative development may still be too high due to the vacancy rate, a shortage of funds, low rental values or high yields. Securing a pre-let can help with all these problems.

3. Later in the cycle, with more schemes under construction, occupiers have more choice and have less need to pre-let. At this stage, some developers may not wish to pre-let, hoping for further rental growth or yield reductions.

4. Once the top of the cycle has passed there is less demand and increasing supply, so pre-lets are uncommon.
For advice and further information, please contact us:

Ian Stringer, National Head of Offices
0121 609 8308
ian.stringer@gvagrimley.co.uk

Howard Cooke, Partner, Corporate Consultancy
020 7911 2376
howard.cooke@gvagrimley.co.uk

Stuart Morley, National Head of Research
020 7911 2427
stuart.morley@gvagrimley.co.uk

www.gvagrimley.co.uk
0870 900 89 90

Published by GVA Grimley LLP – 10 Stratton Street, London W1J 8JR
© copyright GVA Grimley LLP, 2007