The Crash and Rebound of Canary Wharf

Britain's largest office development project has had a rocky ride.

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CANARY WHARF IS Britain's largest office project, incorporating 13 million square feet of development on an 80-acre site, three miles east of London's central business district. Eleven buildings comprising 4.4 million square feet were completed in the first phase in 1992 and included Britain's tallest building, the 50-story One Canada Square tower. The site, called the Docklands, was in a 19th-century harbor and warehouse district that closed in 1980. Subsequently it became part of an Enterprise Zone administered by the London Docklands Development Corporation (LDDC) from 1981 to 1997. The LDDC originally planned light industrial development in the area, but a Texas developer, G. Ware Travelstead, convinced LDDC to consider the site as a location for top-quality corporate offices. LDDC was willing to option and sell the land at low industrial prices, but the project required such large land servicing and construction costs that Travelstead was unable to raise interim financing from banks, and in July 1987 the project was taken over by another developer, Olympia and York Developments.

Olympia and York (O&Y) was a private company owned by the Reichmann family of Toronto. During the 1970s and 1980s, O&Y emerged as one of the world's premier office developers, responsible for the six million square-foot World Financial Center, the centerpiece of New York City's Battery Park City. In 1987, O&Y began the first phase of Canary Wharf. Construction was completed in 1992, on time and only 1 percent over budget. However, O&Y was not able to lease enough of the first phase space at high enough rents to recover the costs. In May 1992, Canary Wharf went into administration, pulling O&Y into bankruptcy in Canada a few weeks later. These bankruptcies destroyed the O&Y empire.

Since real estate development is a risky business, most real estate developers try not to risk their own capital. The standard real estate project at that time included the following financing phases: land acquisition by options; land development loans from a bank; construction financing from a bank; and permanent financing, in the form of a mortgage, from an insurance company or pension fund. A typical project was constructed one building at a time, with each structure set up as a separate, bankruptcy-remote company. Banks usually did not lend unless the building was substantially leased, and take-out permanent financing was in place. At any step in the process, the developer could walk away, losing only a few million dollars at the most, the rest of his assets being sheltered.

Real estate firms in most brownfield projects deal with financing risks by first developing an area immediately adjacent to an existing commercial core. Canary Wharf's isolated location precluded this approach. Instead, O&Y chose a strategy that entailed a large gamble: they would build a critical mass of first-class space in the initial stage so that the project would immediately become a major head office location. This strategy failed for several reasons.

RECESSION

The Reichmanns had established a reputation for capitalizing on real estate cycles with their 1976-77 purchase of the Uris properties in New York City. They consolidated this acquisition by winning the competition for the office development at

Battery Park City in 1980, just before the New York City market peaked. O&Y agreed to build all four towers of the World Financial Center (WFC), and guaranteed the Battery Park City Authority's bond issue, which was nearing default. Between 1980 and 1983, through the peak of the early 1980s boom, O&Y leased six million square feet to blue chip tenants.

WFC opened successfully in 1984-85, and O&Y looked for new projects. London was a tempting development location, as the office vacancy rate was hovering near 5 percent, City of London rents were over £400/square meter, and there was a severe mismatch between the requirements of modern financial institutions and the quality of the available supply. O&Y's research suggested that more than three-quarters of London's office stock was obsolete, with small size, low ceiling heights, structural interference, and awkward floor-plates. In addition, several major corporations' leases were expiring between 1990 and 1992. The window of opportunity was further propped open by the 1987 deregulation of Britain's financial industries. British firms consolidated, while foreign banks and securities companies increased their activities in London.

O&Y took over the Canary Wharf deal in July 1987, just before office vacancy rates began to soar. Demand dropped as Britain slid into a recession, while supply exploded due to new projects in the City of London. During the five years it took to build Canary Wharf, Central London office vacancies rose from 4 percent to 20 percent. In hindsight, it is clear that O&Y bought land at the peak of the London market, and opened their buildings at the trough of the cycle, the reverse of what had happened at WFC. Such timing would bankrupt most developers, even for a modestly speculative project. But O&Y was then one of the world's largest owners of premium office buildings, which had allowed it to use cash flow, rather than conventional financing, for much of the WFC's construction. WFC's status as the largest private office complex ever built was an indicator of O&Y's financial power. Paul Reichmann estimated that it would take at least five to seven years to complete the Canary Wharf project, and Executive Vice President Michael Dennis claimed that O&Y's pro-forma financial plan included not one but two recessions.

COMPETITION

A serious recession would be enough to defeat most commercial developers, but other factors were also at work on Canary Wharf. The chief competition came from the City of London. The Corporation of the City is a unique local government responsible for London's commercial core.

Since it serves few residents and many business owners, it behaves somewhat like a downtown Business Improvement District in an American city. The 1984 Draft Plan took a strong stance towards conserving the architectural heritage of the City, but was widely attacked for constraining the opportunities for further development of modern offices in the financial center. The Corporation reconsidered its conservation policies in light of the proposed 1986 deregulation of financial institutions and allowed another 20 million square feet of offices to be built. Other policies encouraged redevelopment of outdated office buildings, relocation of tenants within the City, and identification of swing space during construction.

This happened before the development of the Docklands. City officials were simply concerned that the poor supply and high cost of office accommodation in the City was hurting its competitive position. It was G. Ware Travelstead who shook them out of their complacency when he unveiled his project and claimed that his new corporate headquarters precinct would cause firms to move from the City.

The City Corporation would not have it. Within a month, the preservationists were in retreat and a new amended plan rapidly achieved its objective of stimulating substantial redevelopment. It permitted so-called groundscrapers — large floor-plate, medium-rise office buildings that took up entire blocks, sometimes incorporating heritage facades. Between 1986 and 1992, more than 45 million square feet of new floor space received planning permissions. The new space arrived on the market during 1989-92, just as O&Y was attempting to lease space at Canary Wharf, and at the beginning of a commercial recession that cut demand. The resulting glut drove vacancy rates from 3 percent in 1987 to 19 percent in 1991; rents declined from £70/square foot in the late 1980s to under £35/square foot in mid-1992.

Plummeting demand and increasing supply were probably not sufficient to cause the demise of the Canary Wharf project. O&Y were marketing high quality, modern office space at less than half of the going rate in the City. By late 1991, they had already leased more than 2 million square feet, almost half the first phase, but they needed to rent another million square feet at their price point to put them over the top.

TRANSPORTATION PROBLEMS

The Canary Wharf legal agreements required LDDC to make substantial capital investments in a relatively short time period. The Docklands Light Railway (DLR), a system running on abandoned viaducts, was to be extended in a tunnel to connect to the Bank underground station. In addition, a new road, the Docklands Highway, was to be built from Canary Wharf to the edge of the City. Construction difficulties and costs kept increasing as planning proceeded. Neither LDDC nor the Boroughs had ever undertaken road construction projects of this scale and complexity, and eventually private construction managers were retained.

DLR was initially unreliable due to teething problems with new technology and construction of the extension to Bank Station, leading to rider frustration and poor publicity. Although the problems were eventually corrected, according to O&Y officials the high profile media coverage of DLR's difficulties damaged Canary Wharf's credibility in the shaky leasing market in 1990-91. Still, after 1992, a new signal system and operational improvements program increased the DLR's reliability to among the best in London, with ridership increasing to 32,000 per day.

The increased costs of road construction and DLR improvements alarmed the Department of the Environment and the Treasury, causing them to get directly involved in negotiations and reducing LDDC's freedom of action. After the need for additional public transit to serve the later stages of Canary Wharf became clear, the national government took over negotiations for the subway extension. O&Y made numerous appeals directly to the government. The approach of the Conservative government, however, was to limit public expenditure by encouraging private investment and ownership. Since O&Y was the primary beneficiary of the expansion, it was required to contribute 41 percent of the £156 million cost of extending DLR to Bank station, the key interchange in the City of London. Capacity increased from 1,600 to 12,000 passengers per hour.

A subway extension became the cornerstone of the government's response to the Docklands transportation problems. The location of stations was negotiated with developers along the corridor, so the proposed route made two additional crossings of the Thames to serve other projects. O&Y agreed to contribute £400 million to the extension, which was estimated to cost £1 billion. The initial DLR extension was ready and operating smoothly the day that the first phase of Canary Wharf opened in 1992. It provided a 10-minute journey to Bank station, and has proved adequate for the demand of the now fully-leased first phase of the project. The Docklands Highway opened two years late, in 1993, and the subway extension was delayed in approvals.

ATTRACTING TENANTS

Although O&Y leased much of the office space in Canary Wharf, by 1992 the tenant list revealed that almost none of the tenants were British corporations. The O&Y team expected that it would be difficult to get British corporations to move from the City. The sheer scale of Canary Wharf was unprecedented in British office development, and the design appeared too American for British taste. But the chief problem was the British corporate culture's traditional attachment to the City of London. Many British chief executives would not move at any price; the City provided them with informal networks of friends, colleagues, restaurants, and private clubs.

As the office market collapsed and London slid into recession, O&Y swallowed its pride and asked for the national government to relocate some of its offices to Canary Wharf. However, the harsh political realities of the Thatcher era precluded any bail-outs. Since Canary Wharf was to be a triumph of capitalism, it had to live or die on its own merits. Ironically, two of the vacant buildings that O&Y was desperately pitching for government occupancy in 1991-92 were later rented at market rates by public agencies: the London Underground and the Financial Service Authority.

FINANCIAL STRUCTURE

The Reichmanns did not follow conventional financing methods. To provide construction financing for the Battery Park City project, they had used cash flow from their entire portfolio of office buildings. They did the same thing in London, borrowing against their other properties, as well as against Canary Wharf. Canadian banks made loans on the basis of O&Y's entire portfolio, with the proceeds being used to finance Canary Wharf. O&Y's "take-out" financing was also unusual. They packaged several of their trophy properties as commercial bonds rather than arranging for conventional long-term mortgages. The bond values were based upon the value of the income from the project — each was a Class A building in a good location with blue chip tenants in secure, long-term leases. The bonds were quickly picked up by institutional investors and financial institutions, who typically rolled them over at the end of each bond's expiry.

O&Y's innovative financial strategy was effective until the spring of 1992. Canary Wharf had been under construction for five years, and was more than 50 percent leased; the first phase was within a few months of completion. Some paying tenants were in place, and others were waiting for the final fitting-out of their offices. Several commercial bonds came due just as the cash demands for building Canary Wharf peaked. Several institutional investors wanted to reduce their exposure to real estate because other developers were going bankrupt and there were doubts about O&Y's capacity, and wanted their cash back rather than rolling over the paper. O&Y could not find new investors. The Reichmanns scrambled to sell off their other corporate assets, but could not find buyers fast enough — and the prices offered were lower than the loans. In March and April 1992, O&Y defaulted on a series of bond and mortgage payments, and in May their entire real estate empire in Canada and Britain slid into bankruptcy. A consortium of banks managed the project from 1993 – 95. They made little progress leasing more space during the recession.

CANARY WHARF RECOVERS

In 1995, Paul Reichmann led a consortium of American and Saudi investors who re-acquired the site from the administrators, at a considerable discount below the construction cost. They established Canary Wharf PLC to complete the project. No other serious bids could be found, given the size of the project and risks associated with future leasing.

Over the next few years, the London office market changed. Prime office rents in Central London bottomed out in 1993, and rents in the Docklands rose from £18/square foot to over £42/square foot in 2001. The vacancy rate in the Docklands declined from over 40 percent to under 2 percent over the same period, while the overall Central London rate declined from 15 percent to 3 percent. Demand for new space and gross on take-up (or leasing) has been strong, but these conventional figures may mask a stable overall market.

Canary Wharf is not the prime location in London but it has air-conditioned, technologically sophisticated, large floorplate buildings, prized by tenants. As a result, the project proved competitive, leasing more than 1 million square feet per year from 1995 to 2001. By 1999, the first phase of the project — only 14 percent occupied at the time of the 1992 bankruptcy — was fully rented. By 2001, ten new buildings were under construction, including two 42-story towers.

The City continued to compete. More than 18 million square feet of modern space was added to the City's stock, using most of the larger sites. Development approval was given to another 11 million square feet, but since these sites were smaller and more difficult to develop they remained dormant. Nevertheless, the City of London remained a strong competitor; it absorbed 56 percent of the market for Class A space in 1998, while the Docklands took 23 percent.

Canary Wharf PLC leased more than 4 million square feet from 1995 to 1999;

its investors were rewarded when the initial public offering (IPO) sold out. The proposed schedule for completion of the project was aggressive: the valuers estimated that it would take five to seven years to lease the remaining 6.3 million square feet. Remarkably, the company leased up even faster than the estimates, signing agreements for the last major building in late 2001. Reichmann optioned additional properties north of Canary Wharf in 2000 to have room for future expansion.

This time, the risks associated with slower leasing are much smaller because single buildings are involved. The shareholders may be upset about a lower return on their investment if buildings start at a slower rate, but billions of pounds are not at stake. Development sites will either be leased or remain vacant, but the expensive infrastructure is almost entirely in place and is a sunk cost.

The constraints on the developer are also different. Paul Reichmann is a minority shareholder in a public company rather than chief executive of a family business. Canary Wharf PLC is a publicly traded corporation that releases audited financial statements and is accountable to its shareholders. Thus, Reichmann is operating under a different set of ownership constraints, which limit the size of the risks he is able to take. The company is structured so that Reichmann receives a modest salary (for a developer), with stock options should the company lease all the space on schedule. The company began a stock repurchase plan in 2001.

SOME BRITISH TENANTS

Canary Wharf has attracted some of the world's largest financial organizations, including Credit Suisse, Citibank, Morgan Stanley, Hong Kong Shanghai Bank, Salomon Smith Barney, the Bank of China, Lehman Bros., and the Bank of Montreal. Yet, despite the transportation improvements, most British bankers continue to prefer the City.

The project made an initial step forward when the British investment firm, Barclays Capital, occupied two buildings in 1997. The new Financial Services Authority and London Underground Limited also leased buildings, so four of the 12 office buildings in the first phase of the project are now occupied by British organizations. In addition, the *Independent, Mirror*, and *Telegraph* newspapers are located in One Canada Square, so Canary Wharf is no longer invisible to London's media. The big breakthrough occurred in December 2001, when Barclays Bank, one of Britain's largest, agreed to lease the last big building on Canary Wharf as their head office. Their one million square foot, 30 story tower should be complete in 2004.

These successes were achieved by offering high-quality buildings at rents considerably below those in the City (£45/square foot vs. £62/square foot, in 2001). Yet most recent tenants are from Hong Kong and the United States. Non-British and non-European firms, not shackled by class bias or the traditions of the City, may continue to be Canary Wharf's primary tenants.

FINANCIAL STRUCTURE

Canary Wharf is proceeding on an incremental basis, with conventional financing. Canary Wharf PLC has committed to erecting buildings only when they have been substantially pre-leased — which is now the normal industry practice — allowing the company to finance an expansion of the project, despite the spectacular bankruptcy of the first phase.

Canary Wharf PLC's financial stability increased in April 1999, when the IPO of its shares sold out. Approximately £520 million of new equity was raised, which repaid the £338 million in loans provided by the consortium of American and Saudi Arabian investors. A portion of the remaining new equity was earmarked to prepay Canary Wharf to Canary Wharf PLC's outstanding commitment toward the cost of the Jubilee Line subway extension. The building-by-building development policy made this risk seem manageable and attractive to the market.

WINNERS AND LOSERS

The Reichmann family was the investor most severely affected by the initial Canary Wharf failure. They lost not only Canary Wharf but also most of their office buildings and equity in Canada, the United States, and Britain. When Paul Reichmann assembled a new group of investors to buy the project back from the administrators for £800 million in 1995, he could contribute only 11 percent of the equity in the project. The consortium of (mostly Canadian) banks that financed the project suffered, but eventually got most of their loans back.

The London Docklands Development Corporation lost credibility and the confidence of its sponsoring government with the collapse of the flagship project. Two chief executives were replaced, a senior Department of the Environment civil servant was installed as CEO, staff and budgets were slashed, and the organization lost much of its freedom of action. Investor confidence in Docklands commercial development was dealt a serious blow, and LDDC's momentum of eastward development halted. Developers walked away from the project area during the recession and much of the land was still vacant seven years later.

The London Underground lost part of its private sector contribution to the Jubilee Line extension when the agreement was re-negotiated. The cost of construction also escalated during the delays in approving the project.

Canary Wharf's early tenants benefited from the project's bankruptcy. Due to a weak market, several of them were able to negotiate favorable leases, with rents that may be below the cost of construction (despite the fact that most tenants are strongly averse to landlord bankruptcy). Other London office occupiers also benefited from the downward pressure on rents caused by vacant space in the Docklands and the City. The remaining heritage fabric and the skyline of the City of London probably benefited from less pressure to build, by this building in small sites.

The land owners adjacent to Canary Wharf both gained and lost. Most were delighted by the rise in their property values when the big plans were unveiled. Many of the early Enterprise Zone properties have been approved for redevelopment but these plans stalled after 1992. The approved projects will increase development adjacent to Canary Wharf from 600,000 square feet to 12 million square feet, if all the projects are built. The north end of the nearby Isle of Dogs will eventually contain more than 25 million square feet of commercial space, about the size of the commercial core of Manchester or Birmingham. The entire area will likely take another decade to complete, with Canary Wharf being completed first, and the other projects following as the market demands.

CONCLUSIONS

The principal transportation lesson is that transportation infrastructure construction is very expensive and subject to delay. Adequate capacity on the move-in day is not sufficient for a major redevelopment project; attracting tenants and residents also requires the early *perception* of accessibility. Of course, adequate transportation is necessary but not sufficient to achieve redevelopment, as DLR has shown. Land use and transportation planning co-ordination work best at the metropolitan level, and some of the worst mistakes regarding Canary Wharf were made in the vacuum left after the abolition of the Greater London Council in 1986. Comprehensive metropolitan economic planning might have identified that there was going to be more office demand than the City could easily accommodate and more than enough to share with a third office node. Since there was no referee in the contest between the City and Canary Wharf, more of the City's built heritage was demolished than was necessary, and the new transportation infrastructure sat idle or under-utilized in the Docklands.

The obvious real estate lesson is that it is hard to create a new market locale, especially at a distance from an upscale city center. Another lesson is that it is better to construct one building at a time, and to not start construction until enough of the project is leased in order to lock-in permanent financing. Since the wave of bankruptcies in the early 1990s, this conservative strategy has been forced by banks upon all commercial developers. Extensive pre-leasing reduces financial risk. However, large-scale redevelopment projects on brownfield sites probably require government to deflect public and private tenants, which is what happened in Paris' La Défènse and New York's ill-fated World Trade Center towers.

There does seem to be some truth in the real estate aphorism that "the only thing worse than a bad idea is a good idea too early." A third office node for London may appear to be a good idea now, but it was not a good idea in 1992. The Docklands was transformed into a good location by transportation investment. The tall tower was a good idea as a marker, but perhaps the first phase needed only six or eight medium-rise buildings to achieve critical mass, rather than the 10 that were built.

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