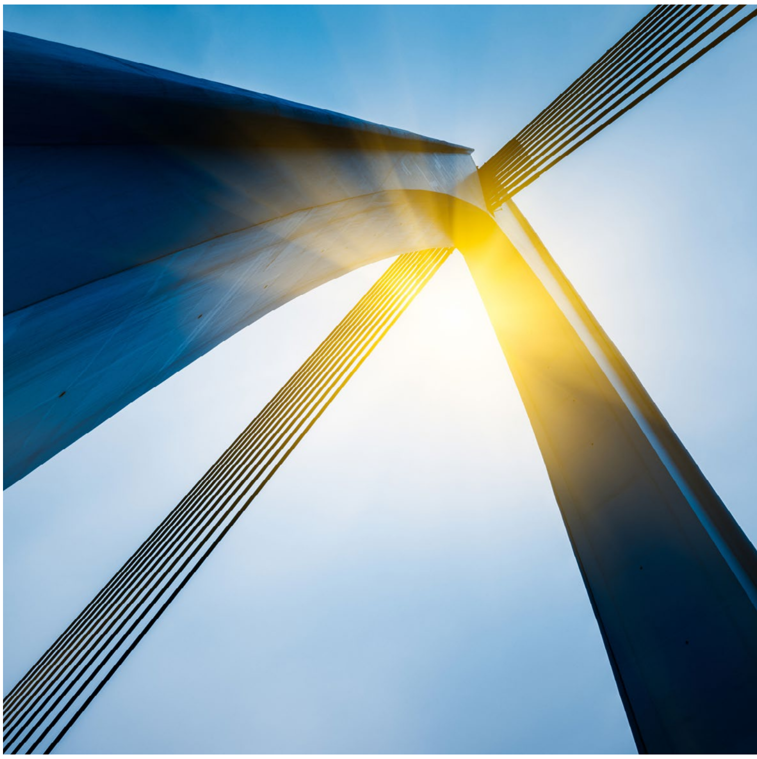
Offices; looking beyond Covid-19



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Key takeaways

- There is clear downside risk to office space demand over the medium-term resultant from changing worker preferences amplified by the COVID-19 pandemic. However, our expectations are more nuanced than some current commentary. We emphasise key mitigants: opinions over the efficiency of home working are not binary; an expectation that some negative views on the office will soften; and an expectation that changes to preferred days in the office will not have a commensurate impact on space demand. Finally, less new space may be built due to cyclical pressures as well as structural concerns and this will reduce the void risk faced by investors.

- Long-term office demand - occupied stock - can be calculated by the intersection of office job forecasts, the density with which we occupy offices, and the utilisation of these offices. Estimates for utilisation range significantly and occupier demand is very sensitive to these estimates. There is therefore a wide range of plausible outcomes. We have sought to minimise this range based on our considered views of mitigants, described above.

- The midpoint of this range in expectations suggests that occupied stock maybe around 5% lower in 2024 than today. This is a material 7% deviation from pre-existing trends but represents a less negative outcome than many currently suggest.

- The risks to investors from reduced space demand are centred on void risk. Therefore, we make an adjustment based on likely implications to supply; developers are likely to build less new stock for both cyclical and structural reasons.

- We estimate a structural increase to vacancy rates in five years' time of 1.8%. Regression analysis suggests this will be associated with a reduction in the long-term rate of rental growth. Using London as an example, a real terms rate of growth of 1.0% would become -0.6%.

- A subsequent report will discuss implications to investment pricing but there are clear implications to strategy which can be summarised as:

  - An increased importance of building quality, effective design, and indoor environmental quality (IEQ) that is better met by new or well refurbished product.

  - An increased importance of occupier engagement necessitating a centralised strategy across portfolios to enable management economies of scale.

  - All else equal this would suggest greater deviation from typical MSCI benchmarks which are characterised by older, smaller properties.

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1. Introduction: Pricing signals

Over the eight months to August office capital values fell -4.1%, according to the MSCI monthly index. This compares to -6.7% for All Property. Within offices, Central London has outperformed with a more marginal reduction of -2.9%. Meanwhile the IPF consensus forecasts shows a peak to trough reduction in office capital values of -7.5% compared with -13.5% for All Property.

Within current industry valuations or forecasts there appears to be no suggestion of structural risk to office values. This seems at odds with the current tone of commentary, some of which suggests the sector faces structural risks of a similar magnitude to retail.

However, REIT pricing signals, using the two London majors as a proxy for London offices, now showed a (de-levered) reduction of -24% over the nine months to September of 2020 – a significant delta of 16.5% to the peak to trough IPF consensus forecast for the same geography. At the all property level the delta is 4%.

This report aims to explain these implied differences in opinion and derive a considered view on the magnitude of risk the sector faces and what this means to strategy.

2. Nuance and arguments

We are still in the relatively early stages of understanding how COVID-19 will affect long-term working patterns, once the virus itself has been beaten. We have attempted to look beyond the adaptations that are required to provide a safe working mode during the pandemic, to the changes that may prove more enduring as these will have the more profound effects on investment value.

Surveys provide quantifiable data on employee and employer opinions. It is therefore tempting to base medium term predictions on them: they are verifiable and, in many cases, provide a data point on which demand assessments can be based; for instance a CBRE global survey showed that “85% of employees would prefer to work from home 2-3 days a week”.

However, we should be cautious about their use. There may be bias in the structuring of the questions or the presentation of the answers and this bias may vary depending on the motivation of the author. More pertinently, most surveys have asked questions of employees as concerns around personal health and safety were most amplified and when mass home working was still a novelty. We have also seen little evidence of how opinions on home working have changed since March.

We would also note that many corporates who have publicly embraced the results of such employee surveys may have cyclical motivations; they support an argument for subletting and cost saving in the near term. These motivations may change as revenues increase and employment growth returns.

Despite these concerns, there is consistency currently: most surveys suggest meaningful downside risks to demand should current views persist and that many workers feel more productive at home. McKinsey, for instance, shows that 80% report that they enjoy working from home; 41% say that they are more productive than they had been before and 28% as productive. Leesman report that 82% of respondents thought their home office enabled them to work productively versus an average of 63% in their traditional office. A YouGov survey, commissioned by Barclays, showed that 27% expected to work from home for in excess of 2 days a week after the pandemic.

However, many arguments about the pros and cons of home and office working offset and mitigate each other. There is a real risk that personal views are projected to the market level. This suggests that the ultimate impact on space demand will be nuanced and less sensational than many suggest; it is not binary.

Factor	Pro-Home working view	Pro-office/anti-home working view
Productivity	Get through administrative tasks and jobs requiring quiet concentration more effectively.	Added value is in idea generation. Productivity depends on the quality of the home set-up. Perceptions of productivity vary by task.
Collaboration	Teams and Zoom provide the tools to meet with and see people, indeed more meetings can happen because there is no travel requirement.	"Zoom fatigue" is recognised as a real issue; the social cues (such as when to speak) are lacking. Effective meetings demand a disciplined agenda that ironically can stifle creativity and prevent knowledge exchange.
Commuting	Money and time saving; equivalent to a 19% pay rise for those on lower quartile salaries in the South East.	Provides daily structure and a chance to clear emails, read (personally or professionally) or just watch TV.
IT	Sufficient to enable the majority of daily requirements.	Desk side support, easy access to equipment, often better and more reliable internet. And no electricity bill.
Learning and development	Collaboration tools and online learning provide opportunities to ask questions of colleagues and learn in a modular, structured way.	The basic questions required when starting a career are stifled; the sense of "occasion" in learning sessions is gone; attention can be diverted by emails without embarrassment. Perception of a lack of career development when not visible. A fear of missing out when colleagues are in the office and you are not.
Ideas and creativity	Collaboration tools and structured meetings should be enough.	The accidental exchanges do not happen, spontaneity can be lost.
Mental health	More personal time and freedom.	There is a human need to "belong" and risks to this may have serious implications (see below).
Physical health	More personal time to take exercise.	Lack of moving, lack of walking, plummeting step counts, poorer diet
Family	Invaluable extra time with families	Distraction, especially outside of school hours
Expensive habits	Significant financial savings on food, work clothes and entertainment.	Boredom and blandness.

3: Productivity

At the centre of the debate around the office is productivity. At the macro level productivity has suffered significantly since March, however that number is occluded by furlough. At a more personalised level many have stated that they feel more productive working from home. However, we must recognise that those who do not feel productive are less likely to shout about it. Anecdotally there have been accounts of productivity softening and/or engagement levels dropping compared with the immediate aftermath of lockdown when there was a greater sense of common purpose and crisis management. We would stress that robust data on this is lacking.

There is compelling academic evidence that collaboration increases productivity[1] and although many would argue advances in software enable effective collaboration the face-to-face nature of idea generation within our knowledge-based economy remains important[2]. Meanwhile, Maslow's hierarchy of needs includes a sense of belonging as a need that motivates human behaviour – just like food, shelter and safety. We therefore do not subscribe to the view that working from home is definitively more productive and suggest that the human and economic requirements for collaboration may be increasingly missed the longer we remain absent from offices.

Data from a recent Leesman survey provides support for this view. Firstly, it does show that most respondents feel they are more productive working from home than they are from an office. Importantly, this perception gap narrows significantly when their office is a good one; something real estate investors can proxy with a well-designed, well managed workplace offering reliability of service, varieties of space from which to work and collaborate and that conveys pride from the point of view of the worker. Furthermore, their analysis shows that perceptions of productivity vary significantly depending on the task in hand. Although intuitive, their evidence is compelling; matters requiring quiet concentration are rated as better from home, tasks requiring collaboration and creativity, and a sense of belonging, less so.

1. A useful example (and one not sponsored by collaboration software) was a Stanford study which found that even the perception of working collaboratively on a task boosted performance: Participants requested to act collaboratively stuck at their task 64% longer than solitary peers, whilst also reporting higher engagement levels, lower fatigue and a higher success rate. This impact persisted for several weeks.
2. Atkin, Chen and Popov: mobile phone data showed how Silicon Valley workers bumping into each other increased patents, Financial Times 28th September 2020

4: Calculating office demand

There are three elements to calculating office demand; the number of office-occupying jobs in an economy, the density with which we occupy offices, and the utilisation of these offices (how many people assigned to a building are in on a typical day).

Independent forecasts from Oxford Economics suggest that there will be 472,000 additional office jobs in 2024 compared to 2019. This includes a short term hit to the economy resultant from COVID. Across Greater London they expect an extra 150,000. This amounts to 4% and 5.5% growth respectively. This is below average but, holding all else equal, would still represent more demand for office space in five years' time.

Over the past 10 years, office space has become more densely occupied. Research from the BCO[3] shows a density rate of 1 workplace per 9.6 sq m compared to 12.5 sq m before the GFC, an increase in density and a reduction of space per workplace of 23%. Before COVID-19 there was an increasing debate over whether densities had been pushed to the limit, with a consensus expectation that further intensification would be limited, slower, or absent. It is a matter of opinion how this may change once we can re-occupy offices safely, but our discussions suggest that – at best -density will be at the same level as before the crisis, but it is more likely to be less dense as workers get used to having more space. We expect the change in density to range between 0% (no change) to a conservative 5% (less dense). This would also be associated with greater demand for office space.

Utilisation is the key variable and estimates for future office demand is very sensitive to it. Before COVID-19 utilisation rates were around 60%[4]. During lockdown that number was effectively zero and in recent weeks agency data suggested it was running between 10 and 20%.

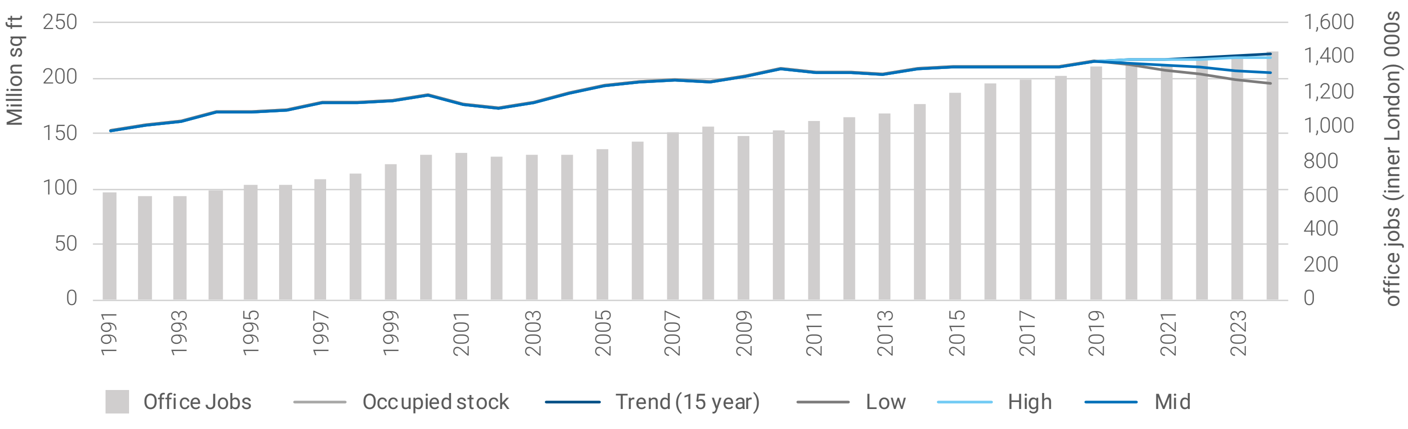
In order to predict utilisation, we have taken a combination of qualitative and quantitative measures. We start with the quantitative – the evidence from current surveys which suggest, for instance, that the median employee preference would be to work from home 2-3 days a week. We then make some qualitative adjustments to this based on:

- The nuance of the arguments highlighted above. i.e. an expectation that the positive arguments in favour of the office will gain traction, especially as more re-enter the workplace and those working from home feel they are missing those benefits.
- The fact that we are not starting from a point of 100% utilisation (i.e. five days a week). Office work had already become more flexible and office provision had, arguably, adjusted to this, especially in more recent leasing deals.
- A reflection that employers have not historically adopted employees' desired working practices without question. We therefore think that as cyclical motivations subside (the motivation of cost savings by releasing space), and jobs growth returns, the current enthusiasm for enabling extensive home working may soften.
- Potential survey bias but more pertinently the timing at which most surveys have been conducted; when concerns over safety were at their highest and mass home working was a novelty, with everyone "in it together". Views may be different assuming there is a vaccine.
- An under reported fact that, without a command and control culture forcing employees to work remotely on prescribed days, there can be no commensurate impact to space requirement (see later).

We therefore work back from current sentiment and suggest that a change to utilisation in five years' time, compared to 2019, of between -20% and -5% is appropriate.

To calculate what this means to space demand, we need to add back on jobs growth and density assumptions. Applying this to current levels of occupied stock suggests a range of impacts of between -15% and +6% with the median being -5%. We would emphasise that this midpoint represents a range of outcomes that we have sought to narrow, as described above.

Changes to Occupied stock: Central London example



Source: CBRE, Oxford Economics, LGIM Real Assets calculations

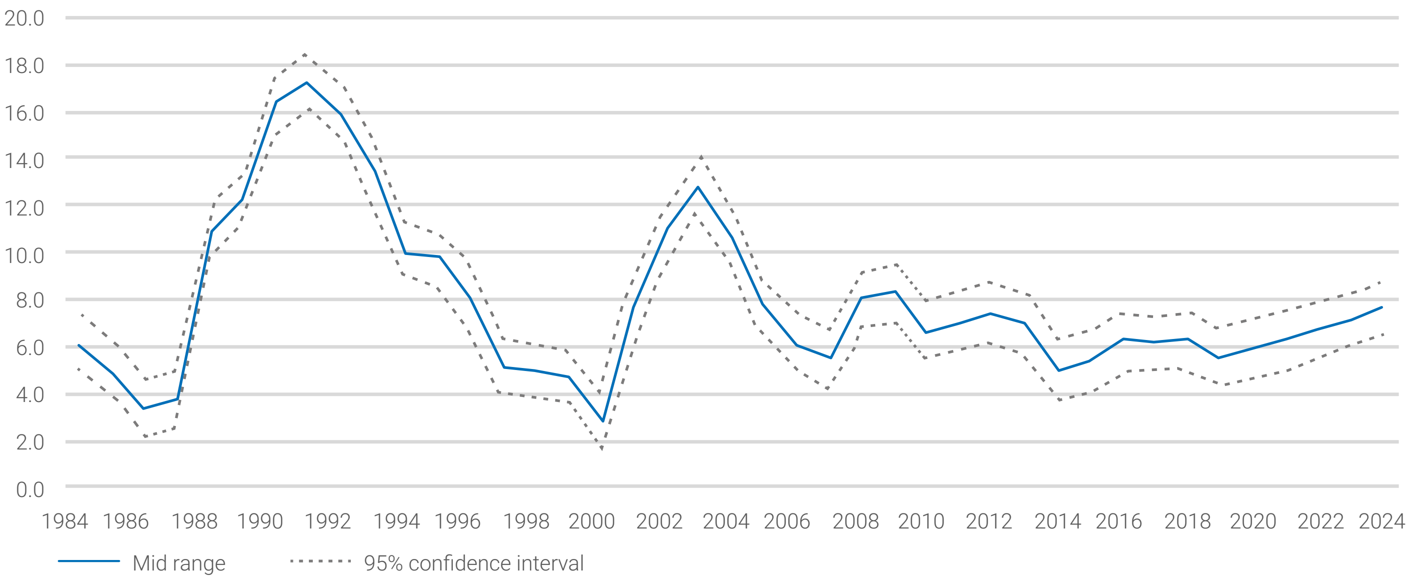
3. BCO, 2018
4. Knight Frank, BCO, 2018

5: Supply vacancy rates and rates

For office investors, risks to office demand translate to heightened void risk. It is therefore important not to consider demand risks in isolation but to also reflect how related changes to new development might impact overall supply. Given the cyclical risks created by COVID-19, an expectation of much tighter lending criteria for speculative development, and valid concerns over future office demand, we expect the level of new development in office markets to be materially lower. An average of previous cycles shows that London speculative development drops by 48%, when the five-year horizon preceding a recession is compared to the subsequent five years. We adopt this average in our calculations. A natural rate of obsolescence of 1.5% p.a. is also adopted, although there is an argument that this rate will increase given an expected preference for newer product, while innovation in planning policy will make conversion away from offices easier.

Applying this expectation to our median view on office demand, and calculating an impact to vacancy rates, suggests a structural increase to vacancy rates of c. 180 basis points. The same guidance about being the midpoint of a range of plausible outcomes applies.

Theoretical impact to vacancy rate of occupied stock changes, assuming a 50% drop in new development and consistent rate of obsolescence



Source: CBRE, LGIM Real Assets calculations

Regressing the historic relationship between vacancy and rental growth suggests a structural impact of around -1.5% in real terms. Applied to the long-term real rate of growth in London of 1.0% p.a., this would become -0.6% p.a..

Feedback loops may mean this will create less incentive for firms to densify and lower costs for providing collaboration space. However, we do not factor that into these forecasts.

6: How to equate lower utilisation to surplus space

Lower average utilisation may not result in a commensurate impact to demand (even when adjusting for density and jobs growth) if there is variance within a working week. Employees who, for example, choose to work from an office three days a week are likely to choose to do so on Tuesday, Wednesday and Thursday. If “free will” is allowed, Wednesday may have close to 100% utilisation, while Monday and Friday would be sparsely occupied. Indeed, based on an actual survey, Leesman calculated a 76% difference in modelled load levels within a typical week. Office space requirements would need to be planned around the busiest day to enable access to a work setting to all who needed it. Only a “command and control” culture, that prescribes the days of a week workers can enter an office, could even out this weekday discrepancy and enable a commensurate impact to space demand. For many, this is not an attractive culture to work under and, even if successfully implemented at first, is something that may conceivably slip without regular enforcement.

7. Summary

This brief summary of more extensive analysis shows that there are clear downside risks to office space demand, relative to trend, but it is our considered view that these risks are more nuanced than many currently suggest. It is consistent with an environment of increased differentiation of product, management approach, and fund management direction. This can be considered an opportunity for those best equipped to navigate.

This should have implications to disposals within existing portfolios and scrutiny applied to new acquisitions and will be explored in a subsequent report.

It is important to emphasise a wide range of potential outcomes, and although we have sought to narrow this range within this report it is appropriate to observe that we cannot be certain about the future quantum of office demand; but we can make informed judgements as to how best to navigate this risk:

1. The risks to older and poorer quality stock have increased significantly as occupiers will seek product offering enhanced and measurable indoor environmental quality (IEQ) and demonstrable health and productivity outcomes, as well as a design which emphasises and enables collaboration and hospitality.

2. The requirement to engage with our occupiers was emphasised further by the crisis and the risks of not doing so have increased. This means more management time. In theory, management economies will be better served by larger buildings. In practice ensuring a consistency of approach through centralised operational models will enable market leading occupier engagement across assets of all sizes.

3. We do not see a long-lasting risk to cities and are consistent in our views on what makes a supportive urban environment for occupiers: education, entrepreneurship, population growth, and the interaction and clustering of buildings and people. There may be a cyclical argument to focus on a smaller number of core locations to mitigate risk, but we do not see a structural reason to change our view, nor do we see technology acting as a substitute to the factors which drive urban success.

4. Taken together, this suggests that office portfolios which offer newer, better designed, and well managed offices in strong locations compared to market averages are more likely to outperform.

5. The MSCI sample is old (80% is over 10 years old) and small (the average lot size in the office sample is £27.9 million). We therefore suggest that office portfolios increasingly deviate from such benchmarks.

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