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UK real estate: offices – finding a new equilibrium

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Chris Ward
Co-head of Asset Management

James Coke
Fund Manager

Covid-19 has had a very visible short-term impact on the office sector, accelerating flexible working trends and calling into question the need for the office as a place of work. While it may have become fashionable in newspaper columns to prophesise the death of the office, the facts on the ground suggest the opposite may be true.

Despite the increase in people working from home, offices have proved resilient in terms of rent collection and capital market volatility, as occupiers have adapted admirably to short-term challenges. Here we examine the longer-term implications for the sector in the face of changing patterns of occupier demand set against the backdrop of fixed carbon reduction targets.

The months following lockdown on 16 March 2020 were testing times for offices. Visit the business district of any major city and it was virtually lifeless. Office workers left when lockdown started, and while they were beginning to return over the summer following Boris Johnson's most recent "work from home if you can" announcement on 22 September, they may not do so again in great numbers until a Covid-19 vaccine is developed.

Despite this, the office sector proved resilient. Rent collection across our office portfolios averaged 90% over Q2 and Q3, which is the highest of all sectors, including industrials. Capital values fell much less than commercial property as a whole, as a result of which total returns for the sector were -0.8% year-to-date (30 September 2020) against -3% recorded by the MSCI UK Monthly All Property Index.

This is very different to the volatility witnessed during the Global Financial Crisis when office occupancy was heavily weighted towards financial services firms who were themselves at the epicentre of the crisis, resulting in the sector delivering total returns of -23.8% in 2008.

Occupational markets are far better diversified now, and investor sentiment, while not ignorant of the sector headwinds, remains positive while the relative investment case against gilts and other international real estate markets is compelling.

Looking ahead

When considering the future of office occupancy, a distinction must be drawn between the short and the medium term. Looking beyond the immediate impact of the pandemic, it is widely believed that Covid-19 has triggered a new paradigm where employees will split their working weeks between the office and the home. How they do so will depend on the sector they work in, their employer's response to a structural shift in work-life patterns, as well as their age and broader personal circumstances.

As long as the pandemic continues to influence social behaviour, offices are likely to remain in limbo. But in the medium term, 12-18 months from now, it is likely that a vaccine will have been developed, people will have returned to the office in some formal capacity and occupancy in the sector will reach a new equilibrium.

But what is that new equilibrium? While we cannot know for certain, there are many reasons to suggest the office will remain integral to corporate operations.

Reasons to be cheerful

Most importantly, human beings are herd animals who need to interact, and offices provide communal space to facilitate those interactions, which are crucial to cementing the identity of a business, sparking innovation and fostering the development of staff. Offices are also beneficial for externally facing functions such as recruitment and business development, providing a "shop window" to potential new staff and clients. Finally, as anyone with young children will testify, the office provides a sanctuary away from home life distractions, where productivity can be maximised. All these factors underpin the core value of the office to corporate occupiers.

Against these factors must be weighed the long-term structural trends towards flexible working and higher-density occupancy, both of which have been factors in our market for some time. We accept the post-pandemic world is unlikely to see all employees returning to the office all of the time, which will have consequences for the volume of space occupiers are likely to require.

Exactly how much space is required depends on the new working patterns companies develop. Prior to the pandemic, sustainable occupational densities were widely debated, following a well-established trend towards higher densities. Typical ratios of about one person per 12 square metres seen in the 2010's were being squeezed to 1:8 square metres and in some cases to 1:6 square metres or below. In the short term, social distancing has required the return to levels of circa 1:12, but we do not believe this will be sustained in the medium term – beyond the pandemic it is likely tenants will quickly revert to 1:8 density rates when it is safe to do so.

Whatever the quantum reduction in floor space demand ends up being, there are a number of reasons the impact of that reduction can be absorbed by active asset management.

Pre-pandemic there was already a quiet revolution taking place in the office sector fuelled by the rise of the technology and serviced office subsectors, which placed additional emphasis on an office's design, flexibility, wellness and dynamism. This is coupled with longstanding requirements that offices run efficiently (in order to minimise cost) and are sustainable (to minimise carbon emissions).

Taken together, the "wish list" for many occupiers makes them more quality-conscious and less cost-conscious, especially in an environment where total costs can be reduced by taking less floor space.

Active managers can exploit these trends to differentiate between the "good office" and the "bad office" by ensuring their assets are well designed and positioned to meet this increasingly demanding occupational criteria. Conversely, passive managers may find their assets miss the mark and fail to let, incurring potentially significant void costs.

Supply constrained

Immediately prior to the pandemic, office supply as measured by the vacancy rate was well below long-run averages in most commercial centres. For instance, 5.3% of space in the City of London was vacant compared with a long-run average of 6.6%. Redevelopment of offices to alternative uses, accelerated through permitted development rights since 2016, removed excess supply and resulted in a relatively constrained core office supply in most markets.

Looking at new supply, 57% of committed central London office development projects are pre-let, according to CBRE, limiting the potential for speculative development to materially increase supply. Heightened risk aversion following the pandemic will ensure further speculative development activity is likely to be curtailed, with the overall result that development supply will not have as negative an impact on rents as was felt in 2008-09.

What might the recovery look like?

What does this mean for occupancy and investment prospects? It is likely that 2021 will see some rental volatility in some markets, as occupiers revisit their requirements (potentially releasing "grey space" back to market) at the same time as pre-committed developments come on line. We may also see examples of serviced office occupiers seeking to return space to landlords. The extent to which rents fall is always defined by the extent to which vacancy rises, but outside the City of London the early signs are that short-term rises in vacancy will be modest. If past cycles provide a good indicator of future prospects, it is also reasonable to assume a modest outward trend in yields to account for falling estimated rental values, though again this will not be universal and good stock selectors should minimise any impact at portfolio level.

However, by 2022, pending a workable vaccine, it is plausible to suggest "Corporate Britain" will have got its house in order and once again be eyeing business expansion. When people do return to the workplace, they will undoubtedly want more from their offices. The sustainability credentials of a building especially are likely to be at a premium – whether that be in terms of employee wellness or carbon efficiency. The growth in demand for carbon-neutral buildings was already accelerating before the pandemic and we anticipate this event will have served to drive that demand even further as opposed to curtailing it.

Conclusions

From a fund management perspective this leads to a number of conclusions:

- No place for complacency – in an environment favouring discerning occupiers, active managers must position buildings correctly to cater to future demand
- Invest now for the recovery – capital projects offer future performance potential, as environmental and financial asset performance become increasingly intertwined
- Capital volatility is a buying opportunity – oversold sectors often present repositioning opportunities, which may be rewarded by valuation upside
- Don't neglect sales – repurposing obsolete offices for alternative uses supports the residual market.

While it may have become fashionable in newspaper columns to prophesise the death of the office, the truth is that the asset class remains integral to corporate operations. While there are short-term headwinds, we believe over the medium- to long-term the office will remain a vibrant and valued place to work, and consequently, in the hands of an active manager, a viable and reliable investment proposition.

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