Research Blast

COVID-19 European Office Markets Series, Edition 4 – July 2020

Working from home will accelerate, but we would be cautious on some of the more extreme recent claims on future workplace strategy.

We expect occupiers to pay an increasing premium for flexibility, quality of office space and core central locations. This will heighten the polarization with secondary assets and locations.

Offices are not expected to suffer the same level of negative capital growth that retail is due to structural shift as the sector is much more adaptable and underpinned by alternative use options.

Cut beneath the noise

Since the outbreak of COVID-19 and the implementation of working from home (WFH) policies across every major European office market, there has been a huge amount of discussion around what this means for the future of the office. Whilst we acknowledge that there are likely to be some lasting impacts as we return to some form of normality, these are generally accelerations of existing trends we already expected to impact the market. Therefore, we would suggest the claims that COVID-19 will be the beginning of the end for the office as we know it, are largely overdone.

Part of the issue with this particular topic is that it is highly subjective and views are often driven by one's personal circumstances and experience. There is a temptation to assume that what might work today, could potentially work indefinitely into the future. In reality the real impact will not be measurable until several years into the future, which makes it very easy for bold claims to be made based on the limited anecdotal evidence currently available. Numerous CEOs of major office occupiers have made such claims, which if taken on face value would imply a major structural shift for the office investment market in Europe. But we have a few reasons to be slightly cautious on these claims, which are discussed below.

How realistic are the working from home claims?

Within weeks of formal lockdowns starting, numerous claims have been made about companies embracing full remote working policies as a permanent feature. Interestingly, many of the most outlandish statements have come from the technology giants including Twitter and Facebook. On the face of it, this is very alarming for European office markets. These, and other, technology companies have become the key drivers of growth demand across many European cities in the post-GFC era. So even a drop off in new demand from these companies would have a significant impact on demand for European office space.

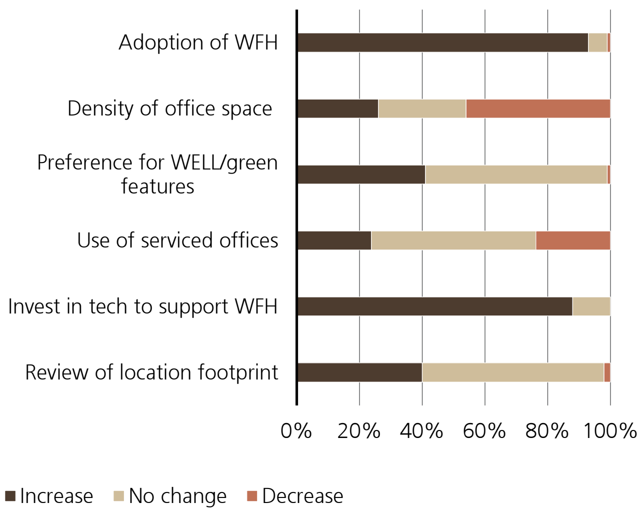
The issue is some of these statements are somewhat contradictory. Over the past decade, these big tech companies have been at the forefront of driving the focus of office occupation on employee attraction and retention. They all rely on intellectual capital and compete for highly skilled creative staff. The office became a key tool in attracting this talent – huge investments were made in some of the highest quality buildings across Europe to create working hubs all focused around the concept of interaction and collaboration between their staff. The recent statements appear to be a complete reversal of this policy. A further big question mark is, why has it taken a global pandemic to suddenly fast forward a major structural shift in workplace strategy? The technology (especially to the companies involved in the sector) for remote working has been available for decades. In theory, the strategies currently being talked about should have been implemented years ago.

The reality is that corporate media statements, particularly regarding real estate strategy, often need to be taken with a pinch of salt. In the current environment they are a win-win. It demonstrates to shareholders a willingness to cut costs, and offers flexibility to employees. Following through with such measures is often a very different reality. One issue with implementing full WFH policies is that many staff do not have the luxury of a home office, and in the most expensive cities such as London where 40% of under 35s live in shared accommodation, home working can be a challenge. The need to provide a desk for those employees who need one will not disappear. This is not to say that we don't see COVID-19 accelerating the WFH trend, but we need to try and quantify some of the claims. There are benefits to certain companies by facilitating non-office working – they can recruit talent more widely and have indicated that pay levels will reflect the costs of living in employees' locations. But a complete U-turn on a decade of policy focused on employee interaction and collaboration in high quality CBD office locations seems unlikely. This has been borne out by the fact that Facebook has been linked to major acquisitions of new space even since the outbreak of COVID-19.

What impact do we see from COVID-19?

Although we do not envisage a world anytime soon where a significant proportion of office-based work is done fully remotely, we do acknowledge that COVID-19 is likely to act as an accelerator of some trends. As the survey data from CBRE in Figure 1 bares out, there is an almost unanimous expectancy that WFH will increase in the future.

Figure 1: "To what extent do you expect there to be a shift in long-term occupier strategy in the following areas after the COVID-19 outbreak?"



Source: CBRE Occupier Survey, June 2020

However, the extent to which this will really impact the office market is highly debatable and subjective. Our view is that the vast majority of staff will remain office-based, but will be given a greater degree of flexibility to decide on which days they come into the office. In this sense, the only significant shift that COVID-19 has delivered is a breakdown of cultural resistance to home working, and indeed many large corporates had embraced this type of flexibility long before the virus outbreak.

So on a very simplistic level, if the trend of flexible working does accelerate and more staff spend more days WFH, there is a net reduction in demand for office space. But translating this into an occupational strategy is not so straightforward. One of the key challenges which has been faced by corporates which have already implemented such policies is right sizing their office for the number of staff coming into the office on any given day. Typically when given a choice most staff tend to work from home on Mondays and Fridays, which creates over/underutilization of space during the week. A further challenge in the short-term will be that hot desking will be restricted, meaning a vast number of unutilized desks on many days of the year, could limit any cost saving potential of increased home working, under the traditional leasing model.

Changing focus of office space

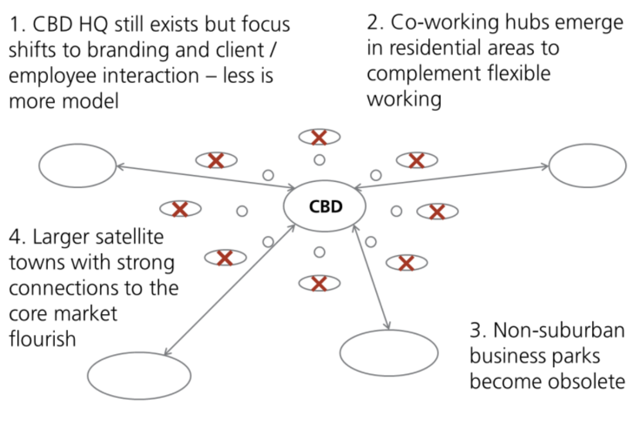
In general terms, most office-based businesses have been able to achieve a reasonable level of business continuity through home working. What is far more challenging however, is implementing any new initiatives to grow business, without being able to meet either colleagues or potential clients in person. The post-COVID office is going to become increasingly focused towards supporting the latter. In essence, if day-to-day functional desk based work can be done remotely, making a journey into an office needs to add additional value. This typically is achieved through interactions. So the focus of the space provided will need to shift away from physical workspace, and more towards interactive and collaborative spaces, meeting rooms and company branding.

This will accelerate the polarization to better quality buildings which have these value-add attributes. The attraction of leasing bland and functional desk based office units will have a decreasing relevance going forward. And although we are uncertain on the future direction of the virus, we expect that even if a vaccine or treatment is found, the memory of the pandemic will maintain a focus on wellbeing features such as advanced HVAC (heating ventilation and air conditioning).

Central locations will be more defensive

In a similar theme, we expect that office locations which offer very limited value-add will struggle to maintain occupancy. Again it is the issue that functional office locations, typically business parks or weaker secondary city locations, will offer very little to enhance the experience of coming into the office. Without that additional value, in terms of both amenities but also proximity to other companies and clients, the value of the workspace element of the office building will diminish.

Figure 2: Future occupational structure



Source: UBS Asset Management, Real Estate & Private Markets (REPM), July 2020. For illustrative purposes only.

It is not just proximity to amenities and clients that we think will polarize performance between central and suburban office space. The expected increase in flexible working could actually have more profound impacts on the residential market, particularly in the larger cities. The length of commute which an employee may be prepared to make if they are only required to be in the office on a few days of the week, rather than five, could increase significantly. So the radius that employees live away from the city center should increase over time. But the office needs to remain accessible for the days which staff does commute into the office. Essentially, this means being located close to the main central public transport hubs to enable the office to be accessible from the widest commutable locations. This gives the company the largest pool of talent to recruit from, and a higher probability of retention. The challenge of non-central suburban locations is that whilst they are extremely convenient for staff living in that part of the city, it is the opposite for employees living elsewhere, and limits the capacity for further decentralized living to make the most of less frequent trips into the office.

There have been some reports on car focused business park space actually being one of the winners of the COVID-19 outbreak, on the basis that commuting by car will be seen as safer than public transit whilst the virus is active. This has some element of truth but only for the very short-term, and not for the horizon that most real estate occupational decisions are taken. For European markets at least, the long-term trends towards sustainable office occupation and increasingly strict regulations on environmental standards will continue to place pressure on car usage, and those office locations which rely on it. The situation is somewhat different in the US, where car usage for commuting is still seen as desirable and public transit is generally less developed than European cities of comparable sizes. And under the current administration at least, environmental concerns are not exactly high on the agenda.

Could offices become the “new retail”?

There is one fundamental key difference between the retail and office sector which should mitigate the negative impact on the overall market. Office buildings have proved to be far more adaptable to changing demand trends in the past, than retail. When office markets become structurally oversupplied, conversion to alternative uses is often viable, particularly in undersupplied residential markets, which most major European cities are. Much of the oversupply built during the dot com boom was never fully utilized as office space, but has since been converted into alternative uses, bringing overall vacancy rates down. City center office buildings are even more defensive, as often residential capital values will be higher than the office value which encourages conversions even during periods of strong office demand. London’s West End office market for example has lost 367,000 sq m of net office space between 2013 and 2019 due to these conversions (Source: PMA, 1Q20).

Even with rents falling, retail floor space remains by some distance the highest capital value real estate. And this makes conversion of large scale retail parks and shopping centers economically unviable in the vast majority of situations. As e-commerce has eroded the volume of floor space required, the oversupply has built-up and it is going to be much harder for that structural vacancy to come down. There is of course a risk that we are too bullish on the future of the office market, and WFH trends accelerates a decline in net absorption faster than we are anticipating. However, with a city center strategy we remain comfortable as the residual land value of office buildings gives us a strong degree of support to capital values as we enter an uncertain environment. Unless demand for the office dies completely, we don’t envisage the same fate for the sector that the retail sector is undergoing.

Real Estate Research & Strategy Team – Europe

Gunnar Herm
Zachary Gauge
Sean Rymell

For more information, please contact:

UBS Asset Management
Real Estate & Private Markets (REPM)
Real Estate Research – Europe

Zachary Gauge
+44 207 901 5534
zachary.gauge@ubs.com

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