

The Office Sector

Almost twelve months to the day since many of us last commuted to the office, Bull and Bear discuss the impacts of Covid on the way we work and what this means for the future of the office sector.

Bull: Here we go again then Bear, another Zoom discussion. I just pray my home wi-fi connection holds up this time and Baby Bear doesn't have a tantrum and throw porridge all over your laptop again. I must tell you; I just can't wait till we can get back to the office when working life returns to normal!

Bear: I agree, Bull. I've been hibernating for too long, but I am intrigued to know what you mean by "normal". The last 12 months haven't just been a blip, they've transformed the way we work. Did you hear Friday's news that Newspaper Publisher Reach, the owner of the Mirror and the Express, is closing its offices and will make most of its employees work from home permanently. You might not have an office to go back to?

Bull: Don't be silly, Bear. You don't really buy-in to all that "death of the office" drivel, do you? You can't work at your kitchen table forever.

Bear: I wouldn't go that far Bull, but firms are looking at homeworking as a viable, long-term solution rather than a Covid-enforced necessity. Just look at what the big banks are doing. Lloyds, for example, is slashing its real estate footprint in the UK, whilst HSBC is reducing its office space globally by 40%. Both lenders cited the mass shift to homeworking as the reason.

Bull: Hmm. I am not so convinced. HSBC and Lloyds were probably trying to convince shareholders they are cutting costs amid a fall in profits. I think these announcements were more driven by dismal news on their balance sheets! It certainly doesn't signal a tidal wave of downsizing across the office market.

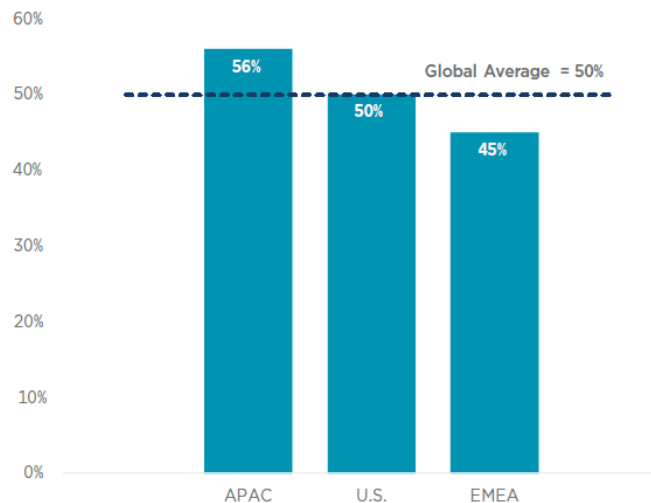
Bear: That remains to be seen, Bull. But the pandemic has only accelerated the trend towards flexible and homeworking. We have the tech to make it happen; there is an argument that working from home is more productive; and if I recall, you were always the first to complain about the train delays on your commute!



Bull: Says the smug cyclist! Listen, I agree there is a trend towards more flexible working, but numerous surveys have highlighted the drawbacks of remote working. How, for example, do you effectively manage your workforce remotely or engender a strong corporate culture? Where is the space for creative decision-making? How do you train younger employees? What about the impacts of isolation on mental health?

Bear: All valid arguments, Bull. We aren't about to see a society-changing shift to an office-free world. Most organisations will still need and want an office. The real question is the magnitude of remote working penetration and the impacts this will have on businesses requirements for space.

Connection to Company Culture during Covid-19



Source: Cushman & Wakefield

Bull: I am not sure we can answer that question yet, Bear. Most occupiers will not be making decisions until they have their feet firmly behind their office desks again.



Bear: True, but many landlords recognise that flexible working is going to be the dominant trend in the post-pandemic future and are already well advanced in flexing their offer to suit this need. Everything in the office sector is going to have some sort of flexibility in it.

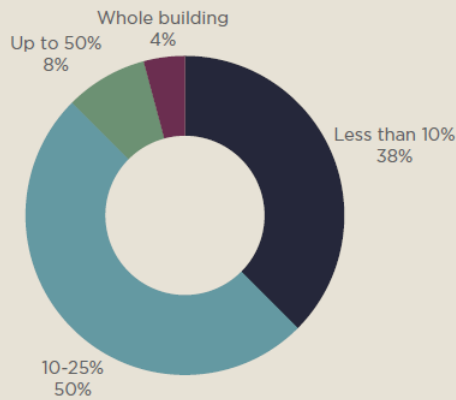
Bull: Do you mean that landlords will need to offer tenants more flexible lease terms?

Bear: Tenants will insist on it, Bull. Savills recently undertook a survey of UK landlords and found that almost a third already operate a flexible offer and another third are planning to develop a flexible offer. A mix of offers in individual buildings will be the way forward. And landlords will be far more willing to let part of their space to a flexible workspace provider or enter into a management agreement with an operator.

Bull: That sounds like a headache for the poor valuer. They'll have to get used to valuing a mix of different types of incomes from serviced and traditional office space within one building.

Bear: Exactly. Something to stimulate those little grey cells of yours, Bull! The operational valuation approach is the new paradigm. Everything in the real estate industry will be about space as a service.

Landlord willingness to let buildings to a flexible provider



Source: Savills

Bull: I hear you, Bear. But what does all this mean for investment into the UK office sector? I read CBRE's 2021 EMEA Investor Intentions Survey this week and London is considered the most attractive city for European real estate investment in 2021. What is more, offices were their preferred asset class. Investors are seeing an opportunity in the sector, not shying away from it.

Bear: The question you have to ask, Bull, is what type of offices are investors targeting? It is all very well targeting super-core office properties with long income, but what about the secondary, higher risk assets? How are they going to fare?

Bull: I'm not sure I follow you.



Bear: Well, according to Savills the amount of grey, or empty office space in the London office market has more than doubled since the first lockdown to 6.1m sq ft. Surely that should ring alarm bells on rents?

Bull: You make it sound like London is awash with second-hand space! I agree that there may be some rental adjustments for lower quality office space, but it really is a different story for Grade-A space. The development pipeline looks thin, so it won't take a huge uptick in demand post-lockdown to put upwards pressure on headline rents again.

Bear: So, can we agree that in a search for yield globally, core has come to the fore? At least that explains why prime yields for West End offices (3.50%) and City Offices (4.00%) have remained unchanged throughout the pandemic, even though the occupiers have all been working from home!

Bull: Yes, and the demand for quality is also linked to another of our favourite topics, ESG. The pandemic has brought a sharp focus on the issues of health, wellbeing, and sustainability. ESG is increasingly important for occupiers' operational performance and ability to recruit, which inevitably means they will focus on high-performing buildings.

Bear: Does that mean we can finally quantify the premium for having good green credentials? I dread to think how many times we've discussed the link between sustainability and value without being able to provide a definitive answer.

Bull: That is certainly the direction of travel. At the very least, we'll start to see a discount for anything that does not satisfy occupiers' ESG requirements.

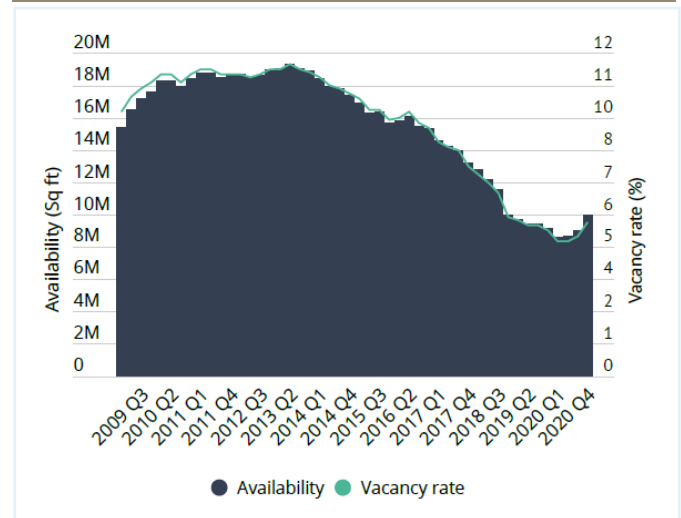
Bear: Talking of travelling (something I have been dreaming about a lot recently!), shall we leave London and discuss the regional office markets? The burning question is what does all this mean for the St Bride's Key Cities strategy?

Bull: It just reinforces the case, my dear Bear.

Bear: It does? From what I've read, investment activity in the regional office sector is pretty muted and prime office yields in the regions softened by 25 bps to 5.0% last year.

Bull: That's hardly a seismic shift Bear! Investor sentiment will strengthen again, but the key point to focus on is the underlying supply/demand dynamics. Supply in the key regional cities remains incredibly low. Just take Bristol, for example. There is currently only 6 months of Grade A supply available.

The Big Nine Availability and Vacancy rate



Source: Avison Young

Bear: So what are these rumours about increased tenant incentives in the market then, Mr Bull-ish?

Bull: That's a response to stay-at-home restrictions, Bear. Top headline rents in five of the big six office markets have actually increased in 2020.

Bear: Wow, I find that staggering.

Bull: I know. The future looks bright for key regional offices and I haven't even mentioned the burgeoning Life Sciences sector yet. There is exceptional demand for large life science clusters such as Oxford and Cambridge.

Bear: Well, I guess the demand for lab space must have shot up. That sounds like the right market to target during a pandemic!

Bull: Quite right, Bear. The supply of laboratory space is exceptionally constrained right across the UK, but in Oxford and Cambridge the vacancy rate is 4% and 0% respectively. You don't see those kind of vacancy figures very often!

Bear: Hold on, Bull. A message just flashed up on my screen. I think we are being timed-out of the Zoom call.



Bull: Don't worry, old friend. Just time for me to sign off with my favourite Jerry Seinfeld quote before we get disconnected; "Energy, attitude and personality cannot be 'remoted' through even the best fibre optic lines." See you back in the office!