Invesco Real Estate webinar: The Outlook for Global Offices

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Introduction

Following the recent experience of many global office employees working from home, debate now rages on the outlook for office demand going forward, including how offices will be used and where companies should choose to locate. At this stage we are a long way from having hard answers to these issues and should expect the final outcome to differ across various markets.

To present the bigger picture regarding how corporates need to think about the provision of workspace, we invited McKinsey to run through their research on the future of work and recent survey findings that pertain to how office use may change. McKinsey approached this by examining first the changing wishes of employees, and secondly the respective costs and benefits to organisations from increased remote and flexible working, before using these factors to draw conclusions as to the changing need for office real estate.

In discussion, our panel concluded that the outlook for aggregate office demand appears to be finely balanced. Employees' desire for greater flexibility can be accommodated by many office employers. This will shift the utilisation of office spaces to further engender collaboration, networking and culture, recognising that more routine and individual tasks can be achieved at least as productively from home. But the aggregate demand for office space is unlikely to change materially, given the need to accommodate a significant majority of the workforce on peak days. However, there will be significant variation as to how this plays out across global office markets, resulting from cultural differences and locally-specific considerations.

Webinar Summary

In the context of global real estate portfolios, MSCI data shows that offices constitute almost 40% of global core real estate, with by far the highest weighting in each region. Hence the topic of the future of the office is absolutely critical for real estate investors.

Over the last decade, innovation hubs and increasingly life science centres have been key drivers of outperformance in the office sector. The chart shown overleaf (Figure 1) shows this by comparing the weighted total returns of the top 30 innovation hub office markets globally with the weighted total return of 50 other global office markets. Innovation hubs outperformed by an average of 283 basis points per year since 2001, and by more than 320 basis points since the GFC. In individual countries and at a submarket level the outperformance has been even stronger.

In terms of determining the relative winners and losers within each office market, there is a huge number of variables that will influence this. However, in terms of core real estate elements, we focus on two major swing factors that will determine the overall pattern. These are (a) the aggregate impact on the demand for office space and (b) the selection of location for offices going forward. It is key here to stress that these are not binary outcomes, but very much a nuanced continuum, and will vary by market.

The chart shown bottom right (Figure 2) summarises some of the key considerations around these swing factors that could influence the future path for office markets. Some issues, such as lower density, only influence the overall demand. Others, such as a focus on collaborative offices, will influence the location selection, while changes like a move to more working from home is likely to shape corporate thinking on both.

McKinsey approached this issue from two angles (a) what employees want and (b) how this means firms should adapt in order to optimise productivity.

McKinsey's surveys have established that a majority of employees appreciate working from home, though this sentiment appears to be waning the longer that this forced situation persists. However, 68% of surveyed employees believe they are at least as productive when working from home. The result is that employees want to increase the time they spend working from home, even after a COVID-19 vaccine, with the average looking to work from home 27% of the time, or ~6 days per month.

Interestingly, McKinsey's surveys of employees' wishes for returning to the office show that people's focus is on improved sanitary measures far more than distancing of desks or the addition of physical partitions. This supports a conclusion that, in many office markets, there will be limited pressure to reduce the density of desk space.

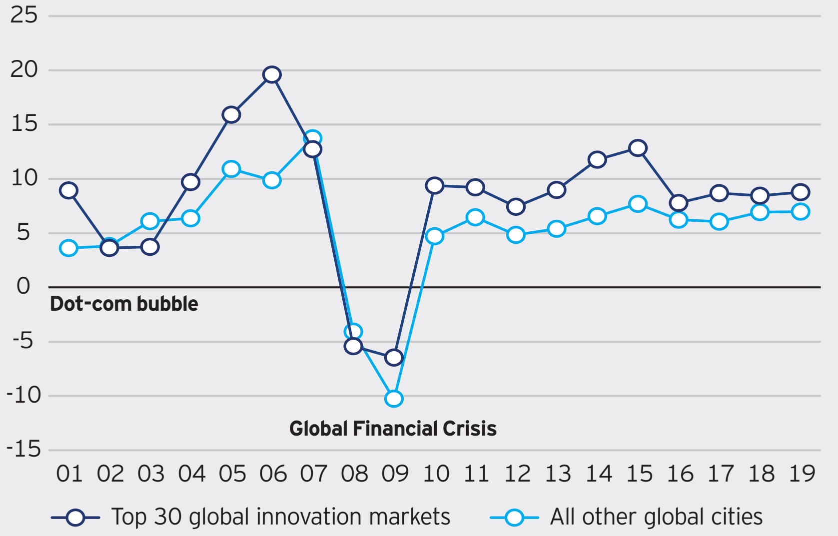
From the perspective of the employer, there is a balance to be struck. Remote work can generate value for businesses, not just through reducing costs and increasing employee satisfaction, but also through improving operational efficiency and organisational resilience, as well as potentially expanding the accessible talent pool.

However, these benefits from remote working should be balanced with a consideration of the tasks performed through the organisation, and which of these benefit from being conducted in-person. The result is that organisations have an opportunity to redesign how the work is done, and to consider the future role of the office accordingly. McKinsey also noted that the share of work that can be done at home varies substantially by sector and differs across the various job functions within the

Figure 1 - Office sector: Targeting innovation-driven office markets

The top innovation hubs around the world have outperformed

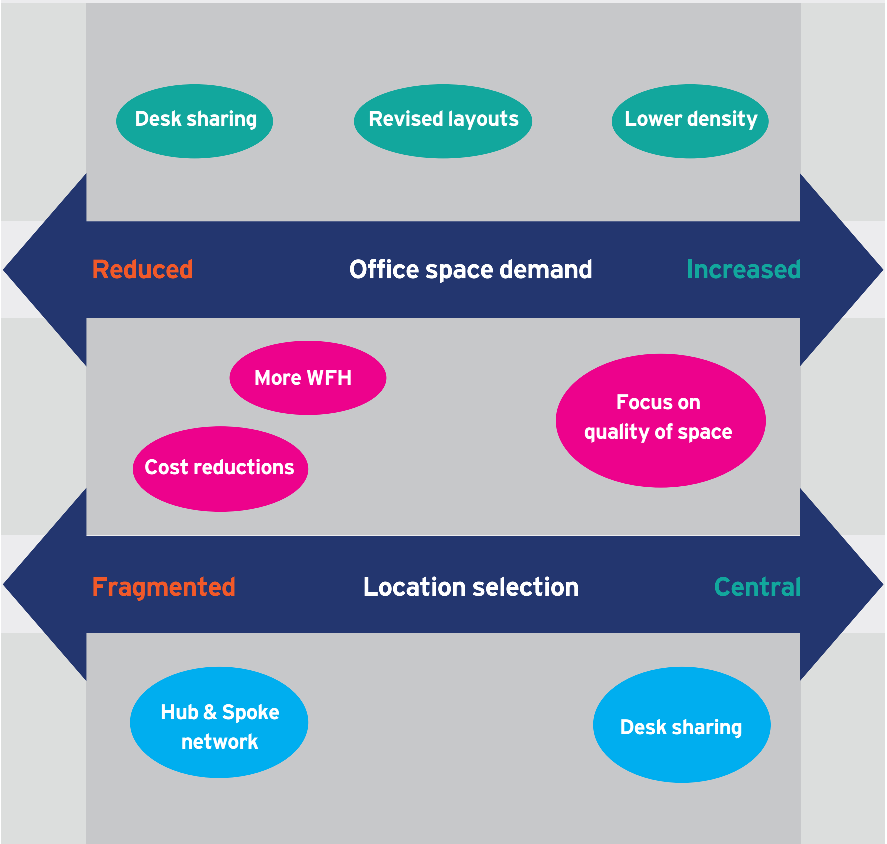
Office sector total returns 2001-19 (%, capital value weighted in US$)



Notes: The top 30 global innovation cities were chosen based on the results of the 2019 2thinknow Innovation Cities Index, which weights 162 indicators against global trends to form a three-factor score for Cultural Assets, Human Infrastructure and Networked Markets. The top 30 markets as of 2019 were: New York, Tokyo, London, Los Angeles, Singapore, Paris, Chicago, Boston, San Francisco/San Jose, Toronto, Melbourne, Berlin, Dallas-Fort Worth, Seoul, Sydney, Seattle, Houston, Atlanta, Washington, DC, Miami, Barcelona, Montreal, San Diego, Philadelphia, Vienna, Beijing, Munich, Madrid, Milan and Amsterdam.

Source: Invesco Real Estate based on data from 2thinknow Innovation Cities Index and MSCI as of May 2020. **Past performance is not a guide to future returns.**

Figure 2 - Global offices: Identifying the changing variables



Source: Invesco Real Estate, July 2020. WFH = Work From Home.

firm. The conclusion was that, when combining the different functions each employee undertakes, there are a limited number of employee's roles that can be done entirely remotely, and therefore that most employees will perform their functions better with some degree of presence in an office.

As a result, McKinsey estimates that there will be a reduction in the percentage of total time worked in both main offices and satellite offices, but that overall employees' desire for greater flexibility is not likely to reduce demand for office space materially, given employers' needs to be able to accommodate most employees on peak days, typically Tuesday to Thursday.

There is considerable debate as to whether firms will accommodate flexibility through a hub-and-spoke network of offices. McKinsey note that this will not suit all firms, as while this does provide flexibility, it alters the economic profile of the business.

Five key client questions during the webinars

We received a number of client questions during the webinar, and here we have taken the five most common themes arising from these.

1. How are Green and ESG considerations likely to link to the post-COVID office theme, and to performance?

This issue cuts through a number of factors as newer, higher quality buildings also tend to be green buildings and WELL[1] rated buildings. Newer and higher quality buildings would typically be a part of the prime market set, and overall newer buildings tend to be higher rated on the ESG scores. At present the prime end of the major European and Asian markets remain more robust in terms of leasing activity and investment demand. So green buildings are currently more resilient from a valuation perspective, there is not necessarily a direct causal link between the ESG rating and the resilience.

Within real estate, a lot of attention has been placed in recent years on the environmental aspects of ESG, e.g., through LEED and BREEAM[2] ratings which assess the environmental efficiency of buildings. However, post-COVID there is some evidence that we are seeing an increasing focus on WELL ratings on buildings, which consider the wellbeing of the occupants. McKinsey's presentation highlighted that health and sanitation provision is increasingly being focussed on by employees.

2. What is the outlook for demand for CBD offices in gateway city markets, and what brings employees to live in these cities?

Historically, office markets that have outperformed are characterised by an increased focus on technology, innovation and life sciences. The panel discussion noted that these industrial clusters are likely to persist, continuing to attract both the employer firms and the employees.

McKinsey noted that urbanisation has been a strong structural trend globally, and is unlikely to reverse post-COVID-19. As such, employees are likely to continue to be drawn to cities where growth industries are centred, sustaining this virtuous circle. An example was Amazon's recent search for a second US hub location, ending up in New York due to the depth of workforce talent.

3. How do these changes materialise given current long leases, and what is the outlook for the long-term office lease structure?

Pre-COVID, we were increasingly seeing large corporates segment their offices requirements into a core element and then taking some flex space either around this or in specific locations to host certain projects, e.g., hosting tech development teams in innovation locations. It seems likely that this will persist, and even accelerate, post-COVID. McKinsey showed that firms will reduce employee work time at the main office and satellite offices, but expect to hold time spent in flex offices flat.

However, this does not mean that the long-term office lease is entirely consigned to history, as it will still likely be the staple structure for the main corporate office, providing certainty and stability for the enterprise. So a greater move to flexibility will marginally reduce the number or scale of long-term corporate leases, but if we do see the expected growth in co-working utilisation, then these longer term leases will be increasingly important to the operators of these flexible spaces.

4. What is the role of co-working and flex offices in the changing workplace?

In terms of demand for flexible offices or co-working spaces, our panel discussion noted that the COVID-19 crisis could be a start of a phase of greater growth for such operators. At the corporate or enterprise level, this links to the previous question, as pre-COVID we were seeing major occupiers taking some flex space either around their core base or in specific locations to host certain projects.

5. Will COVID-19 change the use of open-plan offices or hot-desking formats?

McKinsey presented data on the employee utility of various potential office changes. From this we learn that employees are more concerned about cleanliness than spatial distancing. And the notion of higher cubicle walls had a utility score of 49 (where 100 is average and 200 is twice as valuable as 100), so this would indicate that greater divisions within the office are a low employee priority.

In addition, with an increased focus on the office as a place to communicate and collaborate, this is more easily done in open plan format than in closed offices. Furthermore, if employees are working from home more days each week, there will be less desire from firms to provide them with the greater space that goes with a closed office if they are going to be there less.

The question of hot-desking appears more nuanced. The McKinsey data on this was nearer to being balanced, though this factor was still slightly below neutral in terms of the perceived utility to employees. As such, this would appear likely to become a change that firms may turn to of the need to make other accommodations, e.g., increasing meeting space.

Conclusion

COVID-19 has reinforced and brought into sharp relief many trends that were already influencing the outlook for the office sector.

Looking forward, the aggregate demand for office space may be little changed if any demand lost as businesses allow more working from home is offset by an increase in space provision per head. But the configuration of core office space appears likely to change, with more space devoted to collaboration and flexible occupation.

Prime CBDs, innovation hubs and life science clusters appear likely to remain in strong demand. The outlook for suburban office is less clear; in the near-term demand may increase but in the long-term automation of routine office jobs is likely to be a significant headwind. Asset selection is increasingly important.

Looking forward, it seems likely that there may be a narrower range of winners and a wider range of losers.

Notes

1. WELL Building Standards monitor aspects of a building that impact human health and wellbeing, and is certified by the Green Business Certification Incorporation (GBCI).
2. LEED (Leadership in Energy and Environmental Design) and BREEAM (Building Research Establishment Environmental Assessment Methodology) are two systems for rating buildings' environmental impacts and sustainable credentials.

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