UBS Asset Management

Embracing change

The future of the office sector post-COVID-19 I White paper

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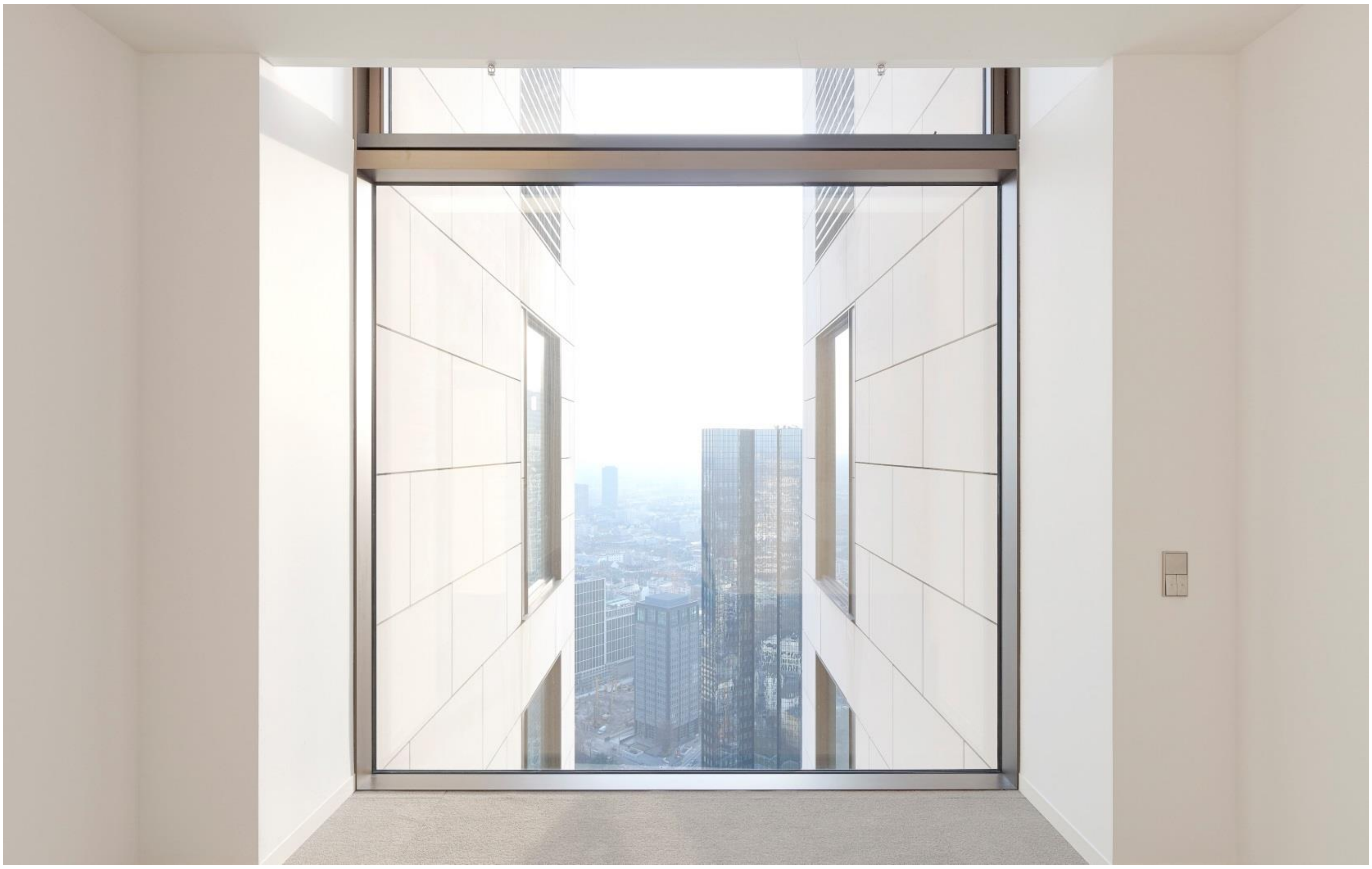


Core and value-add office strategies which follow the three investment principles of purpose, accessibility and ESG, can provide good opportunities.

The death of the office?

The changing function of offices is no new phenomenon and started well before the pandemic. But in these unprecedented times, new technical possibilities and organizational changes have just started to materialize and become accepted.

The corporate workplace is changing
Since the COVID-19 outbreak in March 2020, millions of office workers in Europe have been instructed to work from home (WFH) on a permanent or semi-permanent basis. Affecting so many people's lives, WFH suddenly became a hot topic of conversation, with references to the subject in US newspapers rising by 12000%[1] in March 2020. Suddenly, a topic which was rarely discussed at length outside of the real estate industry, became mainstream news.

WFH was able to offer most office-based companies a surprisingly high level of business continuity in the first wave of the pandemic. This fueled a huge amount of speculation around a concept which can be summarized as *the death of the office*. Therefore, if employees can WFH successfully, do we really need expensive, city center offices to which staff (usually resentfully) need to commute to?

Supporting this concept were numerous bold statements from CEOs, declaring their intention to make WFH a permanent feature of their post COVID-19 strategy. But even at the time, we found these statements hard to quantify. And as COVID-19 restrictions have persisted, the challenges of WFH have become more acutely visible, whilst some of the benefits that an office environment provides, became sorely missed.

Over the second half of 2020, there was a notable shift in the tone of corporate statements around the topic and suggestions of permanent WFH dried up, replaced with a more realistic tone focusing on a balance between home and office working in a post-COVID 19 world. One example of this shift in tone has come from the CEO of Barclays, who back in April 2020 stated that having thousands of workers in one building "may be a thing of the past."

But at the virtual World Economic Forum in January 2021, he echoed the views of many within the financial services industry stating "It's remarkable it's working as well as it is, but I don't think it's sustainable… It will increasingly be a challenge to maintain the culture and collaboration that these large financial institutions seek to have and should have."

This is not to say that COVID-19 won't have a fundamental long-term impact on office occupation, and there will be an acceleration of the adaptation of flexible working policies. But, within these policies the office will remain an integral part. And adapting to those changes and focusing on assets which can deliver the type of workplace we anticipate companies to require in the future, will be fundamental in protecting income from the asset class.

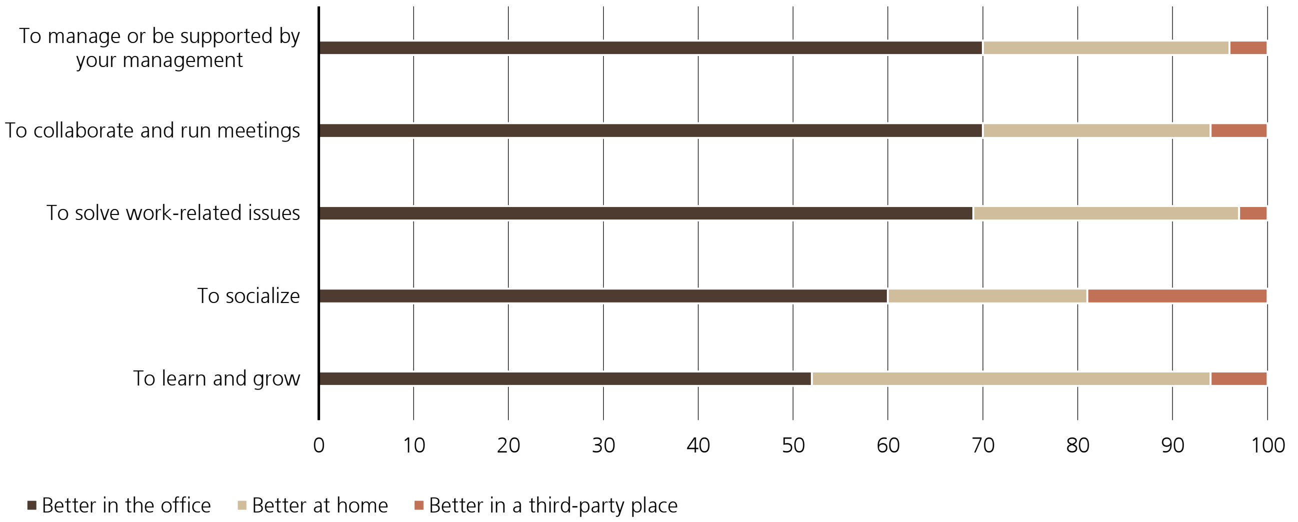
In this paper we discuss the changes in corporate workplace strategy that we anticipate coming out of the pandemic, and how offices will need to be positioned to remain relevant in this environment. For those which can adapt, we remain relatively bullish on the long-term future for the sector. However, as with all structural shifts in real estate, there will be some heavy losers as well.

[1] Newsbank Access World News, December 2020

The importance of human interaction

There is one argument which is fundamental in our belief in the future of the office sector, and is the major limitation on the scope of permanent WFH. The importance of face-to-face human interaction within a working environment cannot be overstated and this experience cannot be satisfactorily substituted by virtual meetings despite technical possibilities. And as the survey results below demonstrate (see Figure 1), the majority of respondents recognize that the office was still the best place for these interactions to occur.

Figure 1: After your recent homeworking experience, where would you prefer to do the following tasks in the future?



Source: JLL; Reimagining Human Experience, November 2020. Based on 2,033 survey responses

These survey results are supported by the only controlled study which has been conducted into home working, which was carried out in 2010 at a Chinese travel agency in Shanghai. The WFH experiment was ultimately a success in terms of measured productivity. Following the experiment, the company decided to introduce a permanent WFH policy. But interestingly, when polled half of the home-based group wanted to go back into the office, with loneliness cited as the biggest reason. And this experiment was carried out with no formal lockdown in place, and the WFH employees still spending one day a week in the office[1].

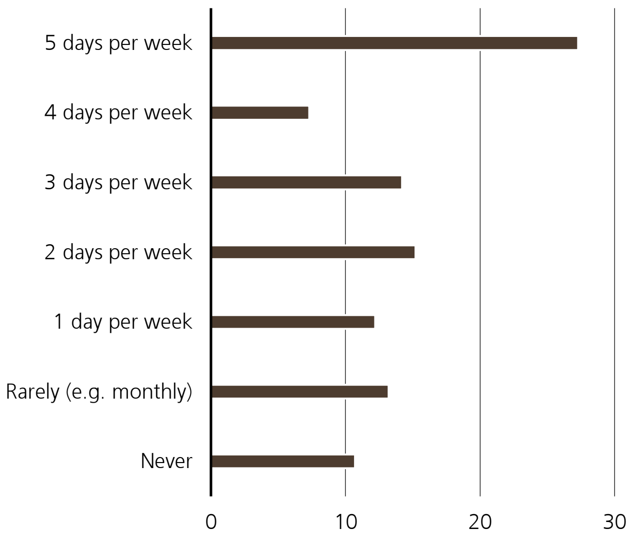
Recent psychology studies have also found that even small and seemingly insignificant human interactions can have a huge bearing on an individual's happiness[2]. Even for naturally introverted people who may prefer to avoid these interactions, the absence of them can have a detrimental impact on their wellbeing. The complete removal of the office experience, including travelling to and from, buying lunch, going to the gym, greeting security guards, receptionists etc. removes huge opportunities for these small interactions to occur that cannot easily be replaced when WFH, particularly during a lockdown.

The impact on corporate real estate strategy

Most large corporates will have carried out employee surveys to gauge the preferences of their workforce for home working post COVID-19. And as Figure 2 illustrates on a broad scale, there is clearly a significant dispersion in the preferences of office-based employees to their future attendance in the office. Unsurprisingly, there are some strong correlations within this survey data – the majority of the 27% who indicate they would like to WFH five days a week were in more senior positions, were higher paid, and lived in larger suburban houses with families and home office facilities. The 10.7% who would never want to WFH were almost exclusively younger employees living in small city center apartments.

[1] Nicholas Bloom; Stanford Institute for Economic Policy Research
[2] Laurie Santos; Yale University; The Science of Happiness

Figure 2: How many days would you like to work from home post COVID-19*?



Source: QuestionPro on behalf of Stamford University, May 2020
* Based on survey of 2,500 US residents earning more than USD 20,000 per year who reported being able to WFH at some point during COVID-19

The challenge for corporate real estate teams is how to balance out these expectations. The first point, is that we expect most companies to still provide an office desk on any day of the week, for an employee that wants to be in the office or needs to be. It would potentially lead to discriminatory issues, if lower paid younger employees were forced to work from home for example, with unsuitable facilities and limited access to training and mentoring.

It was also revealed in the Chinese travel agency study that the WFH cohort had lower promotion rates during the period, than those that went into the office. This is despite the WFH group having higher productivity. For younger staff seeking to move up the career ladder, the office provides an environment to demonstrate their skills and abilities to relevant management, which WFH will never fully be able to replicate.

The second point, is that whilst some senior staff or middle management positions may prefer to not come into the office at all, this is largely impractical for most companies. Managing teams remotely has numerous challenges and having face time with colleagues and in particular younger staff who may require training and mentoring, are essential components of higher paid positions. As such, we do not envisage many companies taking a *free for all* approach to office attendance.

But to balance the demand for more flexibility against the need for face to face interactions and support for younger staff, we expect to see strategies implemented which cluster around the median response, which is to allow working from home two or three days a week for the majority of staff.

Corporates which try to implement this type of hybrid remote working policy are likely to take a structured approach to their employees' office attendance to optimize space usage whilst making sure teams still get the benefits of interaction. So as a very simplistic example: the real estate team could be instructed to come in on Monday, Wednesday and Friday of week A, and Tuesday and Thursday on week B. The finance team (of a similar size), would come in on Tuesday and Thursday of week A and Monday, Wednesday and Friday of week B. Assuming both teams historically sat separately, it creates the opportunity to utilize space more effectively, but it will still not be a like-for-like reduction in their floorspace. As mentioned previously, some employees will need or want to be in the office more regularly than they are advised, so a significant amount of overflow space will be required.

The office needs to add value

The function of the office will change fundamentally to support more formalized WFH arrangements (see Table 1). If an employee is going to commute into the office, then the office and the location itself ultimately needs to add value to making that journey. The internal layout of offices will need to take on a new focus, to reflect the primary reason for being in the office on any given day: interaction. There will be a fundamental shift away from the provision of functional workstations, and a clear focus on meeting rooms and breakout areas. There will still be a requirement for desk space, but the balance between the two will shift significantly.

This is not a completely new concept – many of the large technology firms for example were already seeing the office more as an interactive collaborative space, than a location for workstations. But we expect this approach to become more widespread across industries. Alongside an increase in interactive spaces, we expect the office to become a tool in marketing the company to both employees and clients.

A renewed focus on staff well-being, and high-quality heating, ventilation and cooling systems are likely to persist after the virus itself has been contained. Within this, strong environmental and sustainability credentials of office buildings will rank higher in occupiers' essential requirements.

In a similar theme, the location of the office building will also need to add value. They need to be in close proximity to clients to enable those interactions within the building itself to take place. And for the employee, making a trip into an office surrounded by amenities adds further value to making the journey on that day. Crucially, the office needs to remain easily accessible, in particular by suburban and longer distance rail terminal.

Employees who now only need to be in the office three days a week rather than five, may consider moving further away from the office on the basis that commuting on fewer days makes the longer journey more bearable. But the office must remain easily accessible on the days the employee does go into the office.

If the talent pool starts to disperse further away from the city center, then providing a location which is still easily accessible from those more suburban or even rural locations, will give the corporate the best chance of retaining and attracting talent. Essentially what this is all boiling down to, is central offices being far more defensive than out of town or secondary locations. There was a flurry of excitement during the initial lockdown that suggested business parks were going to have a renaissance because everyone would prefer driving to work during COVID-19.

There was no evidence of this taking off in Europe, and once the health risks subside, we expect some very challenging times for poorly connected business parks. These locations offer very little to enhance the experience of coming into the office. Without that additional value, in terms of amenities but also proximity to other companies and clients, the value of the workspace element of the office building will diminish.

Table 1: Offices - winners and losers post COVID-19

Winners post COVID-19	Losers post COVID-19
City center locations, close to key transport hubs	Poorly connected business parks and few local amenities
Semi-central locations in established office districts with strong amenities and excellent transport connections	Functional office space based predominantly providing workstations
Locations to benefit from major infrastructure developments, e.g. Crossrail, Grand Paris	Secondary markets with employment focused on back office activities
Office designs with focus on interactive spaces and lower desk provisions	Small floorplate buildings with limited scope to reconfigure
Provisions of staff well-being facilities and enhanced heating, ventilation and cooling systems	Offices in predominantly residential areas
Sustainable buildings with excellent environmental credentials	Buildings with weak environmental scores and poor energy efficiency
Flexibility within the building to take additional short-term space	
Well-connected offices within major mixed-use schemes with varied amenity provision e.g. Canary Wharf, La Defense	

Source: UBS Asset Management, Real Estate & Private Markets (REPM), February 2021

The office needs to be sustainable
The outbreak of COVID-19 has generally strengthened investors' commitment towards sustainable real estate investment. This is partly because of the occupational side, where the environmental and sustainability credentials of office buildings rank higher in tenants' essential requirements. Big corporate tenants who often provide better covenants have committed themselves to strong ESG goals as well. Only assets with strong ESG credentials will attract those type of tenants and would ultimately support the asset's valuation and price.

But more importantly, regulation within the EU is changing. From March 2021, all funds which are marketed in the EU are required to assign themselves a sustainability rating. Any fund which assigns itself as an Article 8 product will need to actively promote environmental or social characteristics, while Article 9 products must have sustainable investment as their objective. On an asset level, the sustainability of any future acquisitions will become of much greater importance, as the European Commission but also the national legislators are committed to the Paris Climate Agreement.

The regulator's aim is to move the economy and thus the real estate sector to become carbon neutral by 2050. The residuum will be taxed by a still to be developed system, but will have an effect on the asset's liquidity, valuation and price. Those assets with the strongest credentials will attract an additional premium, whilst inefficient assets which drag on sustainability of a fund are likely to be discounted. Funds should also prepare for greater capex to upgrade the sustainability of their existing portfolio.

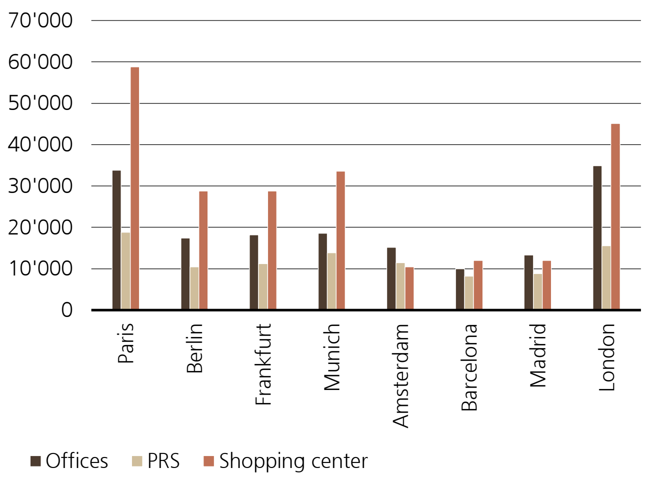
Offices are unlikely to be *the new retail*
Given the significant damage which is being done to retail values from the structural shift to e-commerce, there are some concerns that a structural shift to home working could have a similar impact on office values further down the line. As we have eluded to, for the weaker office locations and assets which fail to move away from a functional workspace environment, there is likely to be accelerating depreciation.

But there is one fundamental 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 residential capital values in specific micro locations can be higher than the office value which encourages conversions even during periods of strong office demand.

For example, a number of major European markets experienced a significant reduction in office stock between 2013-2018, partly due to these conversions. This included London West End, which saw a 317,000sqm reduction in office space, Amsterdam (-321,000sqm) and Frankfurt (-150,000 sqm).

Figure 3: European real estate values (EUR/sqm)



Source: CBRE Erix, 4Q20
Note: PRS = Private Rented Sector

Even with rents falling, retail floorspace generally remains the highest capital value real estate. And the complex and bulky structures of these assets, make them virtually impossible to convert directly into an alternative use. Essentially, they are reduced to land-value after an expensive demolition process. 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 floorspace required, the oversupply has built up and it is going to be much harder for that structural vacancy to come down.

So even if we are too bullish on future office occupancy trends, and the growth in working from home accelerates a decline in net absorption of office space faster than we anticipate, with a city center strategy we remain comfortable as the residual land value of office buildings gives us a strong degree of comfort as we enter an uncertain environment (see Figure 3). Unless demand for the office dies completely, we don't envisage the same fate for the sector that the retail sector is undergoing.

How should an office portfolio be positioned post-COVID-19?
The office has been the main place to execute work for decades. Technology has started to challenge the office's position for some time, but changing organizational structures have been persisting and to a certain extent have resisted changes. COVID-19 can been seen as the catalyst for organizational changes. How can office portfolios adapt and how should investors look at the sector post pandemic?

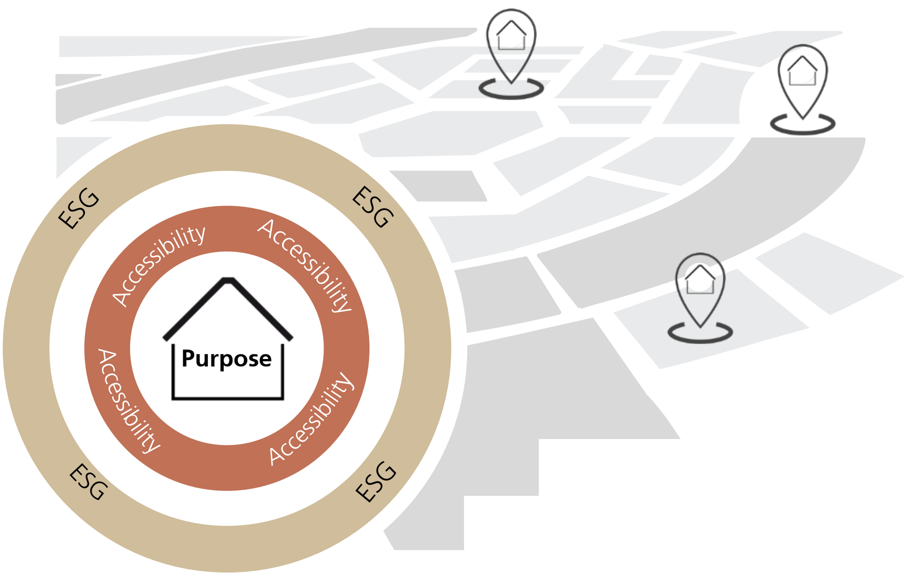
We believe that an office portfolio is based on three principles (see Figure 4):
– its purpose;
– how accessible it is;
– and how it incorporates ESG factors.

Purpose of the asset
As technology changes the way we work, every office portfolio and every investment decision should be viewed from the occupier's perspective:
– Why does the occupier need the space?
– What type of business activity does the occupier use the space for?

Translated to the asset the questions would be:
– Why do tenants want to be in the asset?
– What business functions support the asset?

In essence, the office space offered needs to be meaningful. Looking at the trend post-COVID-19, a meaningful office provides added value when compared to WFH. As discussed above, technology can only substitute social interaction up to a certain point. Offices will be a meeting point for staff and clients. Even prior to the pandemic, meeting clients was always a major rationale for going to the office, but the value of meeting colleagues is likely to increase. The future office will not only support the corporate's brand for clients but also for employees. The company's working culture is likely to also be represented by their office space and supports the company's effort to attract and retain the best talent.

Figure 4: Three principles of an office portfolio



Source: UBS Asset Management, Real Estate & Private Markets (REPM), February 2021

An asset's accessibility
In the future, employees may not need to come to the office every day. However, if they do go to the office the commute must be easy. Considering the European regulator's commitment to the Paris Climate Agreement public transport is likely to play a key role, even if people have been skeptical about using public transport during the pandemic. Ultimately, the regulatory environment is supporting locations which are easily accessible by public transport in the future, meaning for Europe, city center locations are likely to benefit in the long-term. Investment in public transport is likely to increase across Europe and provides guidance for upcoming or strengthening office locations.

Currently, the world's largest infrastructure project in public transport is happening in Paris and provides strong opportunities. But other markets like Copenhagen and Milan, to name only a few, support central office locations. Together with the amenities of a city center, central office properties provide the added value a corporate and an employee is looking for while functional office spaces in non-central and less accessible locations by public transport may deteriorate over time.

Asset's ESG-ness
ESG is and will increasingly be the overarching driver for any real estate investment. Thus, an office portfolio needs to follow ESG principles in order to attract tenants, employees but also to be appealing to the public. Many central office locations already fulfill most of the requirements of an ESG strategy.

In summary, offices will have a future but as the world is changing just providing any office space will not be the answer. Tenants and employees in the office are the investor's customers. Therefore, it is more crucial than ever for the real estate investor to understand and to anticipate the future needs of its customer. A successful office fulfills the purpose of its customers, is highly accessible and meets today's but also tomorrow's ESG standards. The pandemic environment has provided sizable investment opportunities in the core spectrum but also in the value-add space for long-term and ESG minded investors.

The future office portfolio
Considering the above mentioned trends, the future office portfolio is likely to follow a core to value-add profile but ESG is undisputable (see Figure 5). Currently, core strategies are likely to be more easily executable than value-add strategies as the pricing of non-core assets is still strong and may not reflect the necessary capex needed to bring those assets to the new level. We expect that this is likely to change due to shifting regulation and investors' perception on risk.

Figure 5: Factors guiding the future of office investment

Investment Style		Attributes
	Core	– City center or well-established office location – Strong access to public transport and to existing or upcoming infrastructure – Interactive, modern and flexible workspace – Wellbeing and individual employee focused – Strong ESG credentials (certificates) which can follow the Paris Climate Agreement
	Core+ to value-add	– Central but also secondary locations – Good access to public transport – Older buildings which can be upgraded to modern office spaces – Upgrade to modern ESG credentials

Source: UBS Asset Management, Real Estate & Private Markets (REPM), February 2021

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