December 2020

Offices are not dead, but they will need to evolve

Adrian Benedict
Head of Real Estate Solutions

Kim Politzer
Director of Research - European Real Estate

Have white-collar workers become a species of pyjama-clad recluses? The British clothing retailer Primark certainly gave that impression in November when it reported a rise in nightwear and leisurewear sales since the start of the Covid-19 pandemic. By contrast, sales of formal menswear have fallen by three quarters in the six months to August leaving retailer TM Lewin, for example, to shutter its entire estate of stores.[1]

Working from home became the norm for many in 2020 as companies shielded staff from the coronavirus, often at the direction of governments. Many offices have been sparsely attended, if at all. But they are not dead. And we think it unwise to extrapolate future trends from the extraordinary circumstances we have lived through. After the pandemic, offices will remain vital for many types of business, although to stay attractive to occupiers, offices will need to evolve.

Offices and shops are different

Real estate markets already faced disruption on several fronts before Covid-19. The biggest was the rise in online shopping which took business from high street stores (and hurt the rental values associated with them). Investors had already begun to question how city centres might change as a result. Then, when the virus came, online shopping spiked as non-essential retail shut down. The rise in working from home prompted similar concerns about the future of the office. But offices depend on a different set of dynamics to retail. Any disruption to the office sector caused by the pandemic is likely to be far more nuanced and to differ across regions, cities and sectors.

A new definition of 'prime'

In this context, the traditional approach to real estate investing of buying trophy assets in prime locations is unlikely to be as effective in the 2020s as it has been in the past. Instead, we expect the new 'prime' to have income sustainability and tenant viability at its core. Green credentials will be a big differentiator, for investors and for occupiers, while accessibility and amenities will influence how often workers commute in and the value an office adds to a tenant's business.

Income sustainability is paramount

At present, sustainability of income is uppermost in investors' minds. The pandemic has raised questions around the ability of landlords to collect rent. This is not just because many occupiers' revenues (and ability to pay) have been hit hard by Covid. We also detect a shift in tone towards enforcement of rent collection. Previously, landlords could expect to have the support of the law when dealing with an occupier who wasn't paying rent. However, some jurisdictions have challenged this by mandating rent deferrals and imposing a moratorium on entering and reclaiming premises during the pandemic. Such rules may be reversed after Covid, but the door has been opened to a new kind of risk for landlords.

At Fidelity International, we have always sought to understand the creditworthiness of our occupiers but, in the wake of Covid, we have stepped up our approach. As well as using company data to assess an occupier's financial strength and default probability, we draw on cross-asset class insights from the Fidelity equity and fixed income research teams. These give us a unique, forward-

[1]Source: https://www.drapersonline.com/insight/analysis/changing-suit-how-mens-formalwear-has-pivoted-for-covid

looking view of the sustainability of tenants' business models and the dynamics of the sector in which they operate. For example, our real estate team has worked closely with our technology sector analysts this year. Tech companies tend to be in the vanguard of office trends, and these conversations help the team assess the types of office building for which there will be the greatest demand in the future.

Three themes at work

In our view, three themes will most influence office markets over the next decade:

- **Disruption** - as described above, virus restrictions have caused a sudden jump in the number of people working from home, leaving a lot of office space underused. But the arrival of vaccines may change this dynamic again in 2021.
- **Economic cycle** - the pandemic-induced recession continues to cause job losses, putting downward pressure on office demand. This will slowly reverse as economies recover.
- **Evolution** - the way businesses use offices will change, with more spaces for collaboration and amenities.

1. Disruption: How often will we work from home?

The sudden surge in working from home prompted a raft of headlines about the death of the office. The reality is likely to be more nuanced. A survey published by Harvard Business School in August 2020 estimated that a sixth of employees will work from home two days a week on average, after the Covid-19 pandemic.[2] At first glance, this might seem reasonable. Working from home is not a new phenomenon, and its incidence has risen steadily by 3-4 per cent a year for the last decade.[3]

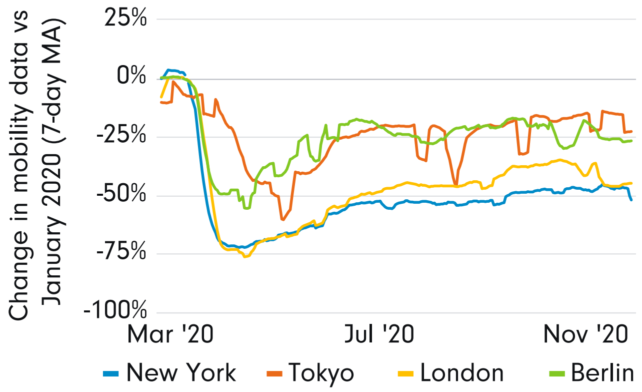
Yet the recent disruption to working life may prove temporary. Technology has facilitated working from home but not revolutionised it. Video calls and instant messaging are poor substitutes for face-to-face interaction. And not just for formal meetings, but also for those chance watercooler conversations on which creativity thrives.

When the virus's threat recedes, we expect many businesses will want a critical mass of employees to attend the office to benefit from collaboration. From a legal perspective, it is unclear who would be responsible for conducting workstation assessments in a world of permanent mass working from home. Some jurisdictions could put the burden on the employer to ensure home workstations are safe. Faced with this additional cost, employers may opt for more traditional working practices.

But employee preferences will matter too. Some have embraced the commute-free lifestyle, while others cannot wait to get back to the office. In general, those aged over 40 with larger homes and older children have found it easier to adapt. Under 30s, often living in shared accommodation, have in many cases been working 'at the ironing board' in their bedrooms, and were among the first back to offices that reopened over the summer. According to Google Workplace Mobility Data, New York, Tokyo, London and Berlin all saw workplace activity rebound when restrictions were lifted.

[2]Source: https://www.drapersonline.com/insight/analysis/changing-suit-how-mens-formalwear-has-pivoted-for-covid
[3]Source: https://www.drapersonline.com/insight/analysis/changing-suit-how-mens-formalwear-has-pivoted-for-covid

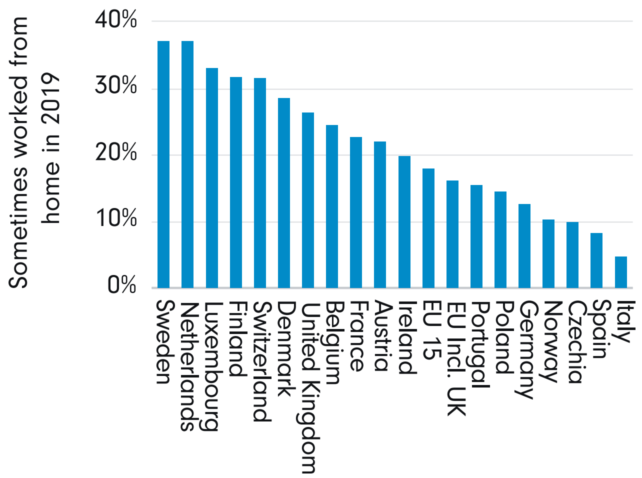
Chart 1: Many people prefer to work in the office



Source: Google LLC, Google COVID-19 Community Mobility Reports, November 2020.

Preferences are likely to differ across geographies. For example, homes in some Asia Pacific countries tend to be smaller and less suited to home-working. Some countries have a greater culture of presenteeism than others. In Europe, the culture of working from home is less well established in Germany than in, say, Luxembourg or the Netherlands. Equally, it has not been the norm in the US. While this may create more disruption if working from home takes root in these countries, it could just as easily trigger a greater desire to return to the office once the pandemic has passed.

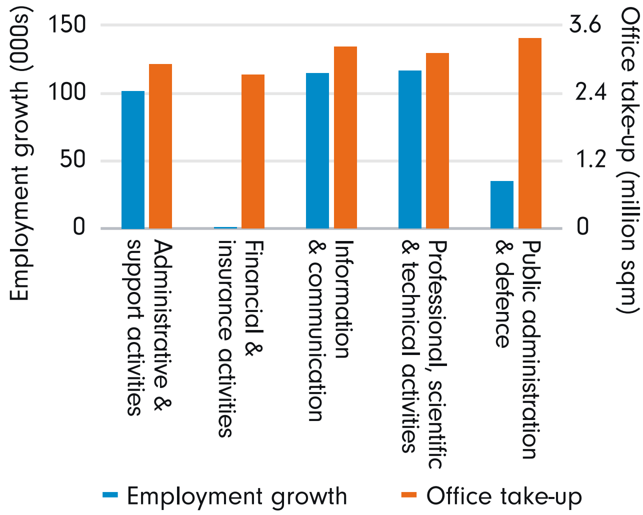
Chart 2: Home working varied across Europe before Covid



Source: Eurostat, 2020, showing data for 2019.

Sector-specific trends will come into play. Financial services such as banks often sign leases for office space three to five years ahead of when they might need it. This makes them more exposed to changes in economic circumstances. The chart below shows how the sector has seen office take-up outstrip employment in the three years leading up to the pandemic resulting in banks occupying more space than they need.

Chart 3: Banks appear to have taken more space than they need



Source: Fidelity International, CBRE, Oxford Econometrics October 2020. Employment growth shows office-based jobs added by sector (left-hand side) between Q1 2017 and Q2 2020. Office take-up shows amount of extra office space taken up (right-hand side) over the same period.

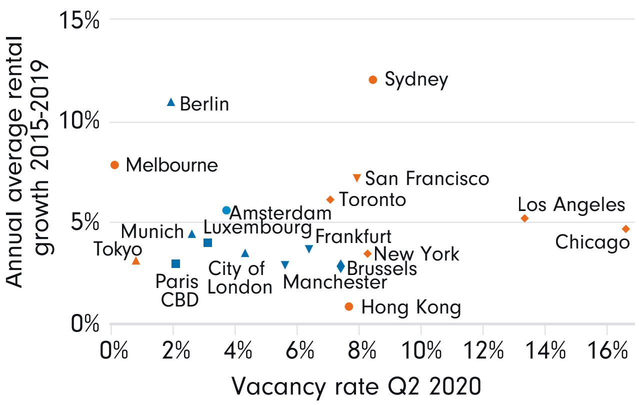
As a result of the latest crisis, several banks have already announced they will reduce the amount of office space they rent. The pandemic has shown that, with the right security features in place, more trading activity can be done from home. This disruption, coupled with the cyclical mismatch between office space and jobs growth, means banking office space may be less sought after.

2. Economic cycle: Employment growth will be the biggest driver of office rents in the next few years

More working from home may have disruptive effects, but we believe the economic cycle will be the main factor that drives office demand over the next few years. Some countries and cities are more vulnerable to a cyclical correction than others. For example, Europe's property cycle is three to four years behind that of the US, as Europe's sovereign debt crisis impeded its recovery from the global financial crisis.

As a result, the supply of office space in Europe has not risen as much as in the US, which has gone through a full development cycle over the last decade. Several US cities currently have high and rising vacancy rates combined with high and rising rents, making them more vulnerable to correction. By contrast, European cities, sitting mainly in the bottom-left of the chart below, have lower vacancy rates and have had only modest rental growth in recent years. This means rents are more affordable relative to other cities globally which may make these areas more resilient as more tenants seek out less expensive properties.

Chart 4: European cities appear more resilient

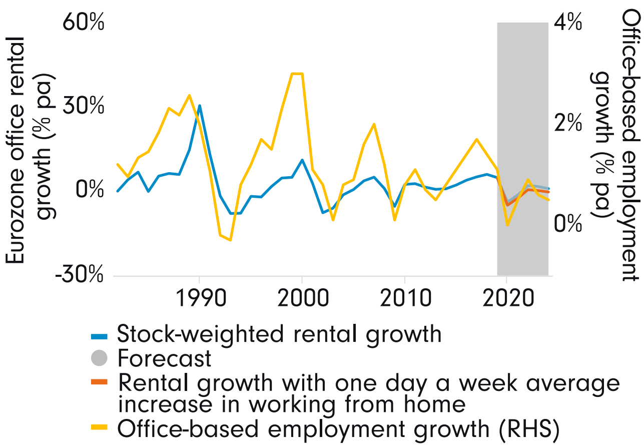


Source: Fidelity International based on data from JLL and CBRE, Q2 2020.

More generally, as the next chart shows, there is a longstanding relationship between office-based employment growth and office rents. Working from home may increase but it is unlikely to produce a corresponding decline in office demand. Instead, newly surplus space will be used for other purposes. In the short term, it makes for a safer, socially distanced working environment. In the medium to long term, we expect more space to be given over to collaborative working and wellness programmes (see below).

Our modelling suggests that if the average number of days worked from home across the Eurozone rises from 0-1 days a week before the pandemic to 1-2 days a week after it recedes, this will have only a modest impact on rental growth.

Chart 5: Employment growth is a bigger factor than working from home



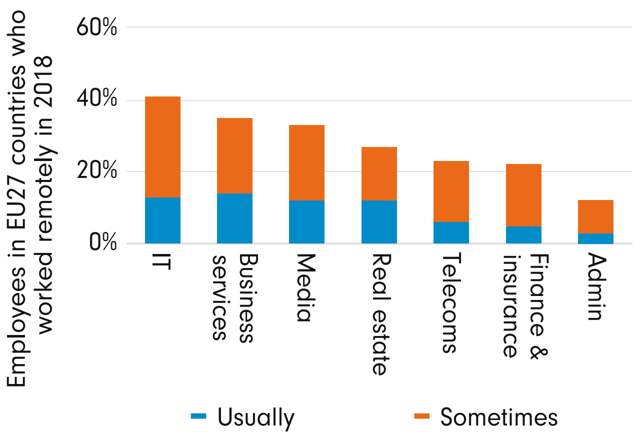
Source: Fidelity International, JLL, Oxford Economics, October 2020.

Office rental growth after the pandemic will be less a question of how often office workers are doing their jobs from home than of how many are working in office jobs full stop. Rents are likely to decline over the next 12-18 months as more jobs are lost due to the fallout from Covid-19. After that, we expect a cyclical upswing, which should, in turn, support demand for office space. For a lot of businesses, office rent is a relatively small proportion of costs, and should become less critical as the recovery takes hold.

3. Evolution: The post-pandemic office

To get an idea of how offices may evolve after Covid, we can look at sectors like information technology, where a mix of office and home working was already well established before the pandemic.

Chart 6: Work cultures already differed significantly across sectors pre-Covid



Source: European Commission: Telework in the EU before and after the COVID-19: where we were, where we head to, 2020.

Google, for example, is pressing ahead with its new 870,000 square foot headquarters in London's King's Cross, which is planned to have plenty of space for collaboration, as well as sports facilities including a swimming pool and rooftop running track. This is despite announcing in July 2020 that its workforce could continue to work from home until at least summer 2021.

This vision of the future suggests offices will become a company's central hub for collaboration, culture and career development. A place where people go specifically to meet, while doing more of their day-to-day screen-based work at home. We would expect fewer rows of open-plan desks and more meeting rooms, as well as more quiet spaces for those who need somewhere to concentrate.

The office of the future: Green, amenity-rich and accessible

Offices of the future will also need to be green. As environmental, social and governance (ESG) considerations become mainstream, company boards are unwilling to rent buildings that don't support their mandated ESG targets. Both owners and occupiers may be required to identify areas for improvement, depending on the kind of green regulation that emerges in the 2020s.

This vision of the future suggests offices will become a company's central hub for collaboration, culture and career development.

We suspect there may already be a 'brown discount' on some properties that don't measure up on sustainable metrics. To protect values, buildings will need to be as environmentally friendly as possible. Expect not only more use of renewable energy and better insulation, but also more rooftop gardens, vacuum drainage toilets, and on-site facilities for processing food waste.

As well as creating more collaborative spaces, companies may invest in amenities to attract talent and persuade employees to come in on a regular basis. The key will be to provide practical facilities that get used. Think gyms, yoga spaces and, for larger occupiers, on-site doctors, nurses and mental health resources. Showers and cycle storage will continue to be in demand as standard. Companies that lack these facilities could find themselves at a disadvantage.

In Europe, we expect office workers to return to public transport once the virus is under control, reviving demand for accessible offices close to transport hubs and shops. We are yet to be convinced that there will be more demand for smaller satellite offices outside large city centres. While this 'hub and spoke' model may suit some smaller cities, there does not appear to be sufficient scale in local suburban markets for it to be viable; in other words, companies won't be able to persuade enough employees to use the facilities to justify having the space.

The story is likely to be different in the US, where cars are a more popular way of commuting. We expect office space in some states to shift out of big city centres to suburbs and smaller cities as companies seek to offer employees greater flexibility about where they work.

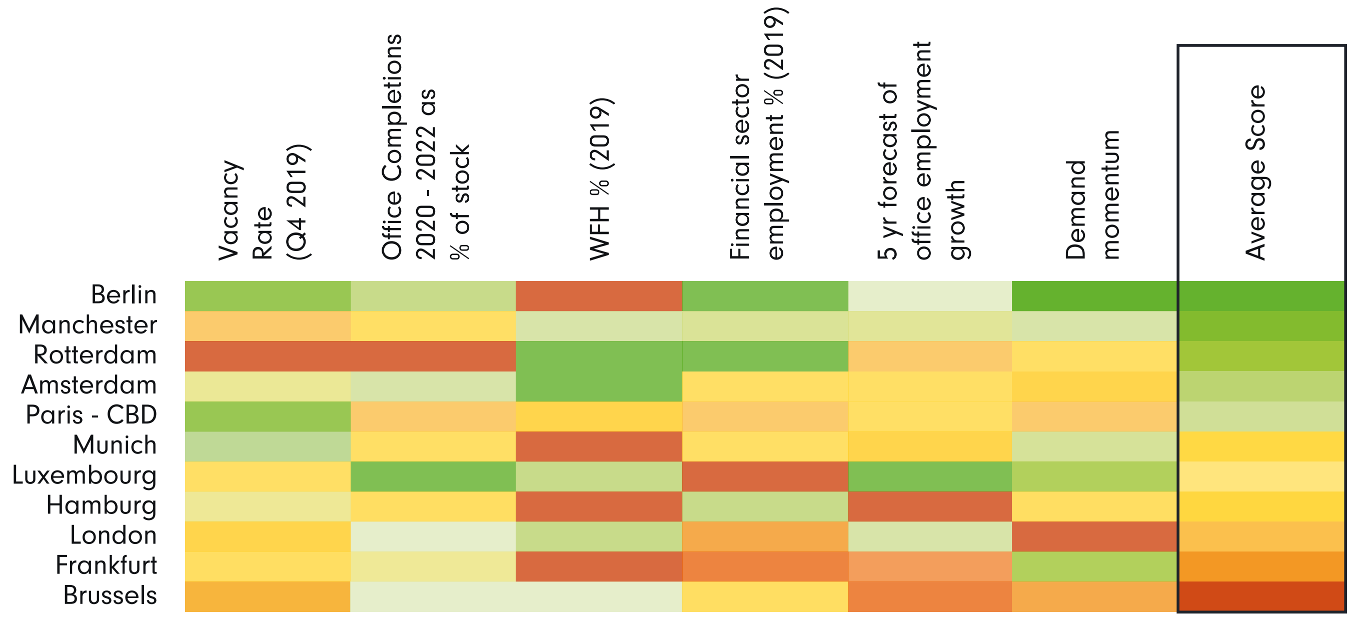
Local nuances matter

Across the globe, office supply and demand, labour market conditions, affordability of rents and the make-up of occupier types will continue to affect rental values, and ultimately sustainability of income. But local nuances will also matter, particularly in relation to the three forces we have identified: disruption from more home working, the cyclical impact of job losses followed by recovery, and the evolution of offices.

Assessing the risks of each theme across regions, cities and even individual buildings will be crucial. Chart 7 shows our proprietary risk matrix that compares the effects of potential risks across various European cities, including that of more working from home (WFH). This matrix doesn't preclude finding investment opportunities in those cities with lower average scores. Instead, it offers a snapshot as to where some types of risk may be higher.

Scooters sit in a hallway for use by employees. (Credit: Spencer Platt / Staff, Getty Images)

Chart 7: Risk matrix of working from home impact by city



Sources: Fidelity International, using data from Oxford Economics, CBRE, JLL, European Commission, 2020.

An integral part of working life

Unlike some other types of premises, offices can be adapted to accommodate all sorts of potential occupiers: from lawyers who prefer dozens of cellular offices to tech companies that want plenty of collaborative space. This is good news for investors. For all the buzz about working from home, we believe offices will remain an integral part of working life. Their spaces and sector dynamics will change; and income sustainability will be paramount. But as vaccines are rolled out over the next few months, we may find ourselves back in the office sooner than we thought, coffee in hand and with less need for those new pyjamas.

For all the buzz about working from home, we believe offices will remain an integral part of working life.

Important Information

Fidelity
INTERNATIONAL