THE Frontier Line

Thought leadership and insights from Frontier Advisors

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The office sector and the workplace of tomorrow

FRONTIER ADVISORS

Frontier Advisors

Frontier Advisors has been at the forefront of institutional investment advice in Australia for over two decades and provides advice over more than $400B in assets across the superannuation, charity, public sector and higher education sectors.

Frontier's purpose is to enable our clients to generate superior investment and business outcomes through knowledge sharing, customisation, client empowering technology and an alignment and focus unconstrained by product or manager conflict.

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Jennifer Johnstone-Kaiser joined Frontier in January 2018. Jennifer leads Frontier's property research program providing consulting and research for clients, both domestically and globally. Jennifer has held many senior positions, most recently as Country Head and Director of Business Development with Savills Investment Management. Before this Jennifer was Mercer's Head of Real Estate - Asia Pacific and worked with consultancy firm Pinnacle Property Group. Jennifer is a Senior Fellow of Finsia and sits on the Property Council's Market Trends Roundtable and Global Investment Group. She holds a Master of Finance and Bachelor of Business, Property (Distinction).

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Introduction

The office sector currently makes up the largest portion of most domestic investors' property exposure (~ 50%), of which the majority is invested in Australian office assets. Home bias and lack of diversification pose a significant risk. In 2019, we flagged our concerns around increasing supply for the office sector in 2021 to 2023, particularly in Melbourne and Sydney. These concerns have now been exacerbated by COVID-19.

The changing composition of the investable universe holds ramifications for portfolio construction and allocations. In this paper we discuss our views and observations in a series of reports on the office sector.

In previous papers, we discussed the ongoing macro-economic headwinds, contraction of GDP and the consequential impact for demand of office stock. In this publication, we delve deeper into:

- Key drivers that impact the Australian office sector and we examine historic relationships between higher unemployment, increasing vacancies and net effective rents and what this could mean for capital values over the next 12 to 36 months.
- An examination of the Work from Home (WFH) trend. Our modelling shows that a small uplift in vacancies can have a dramatic effect on capital values.

The greatest threat to future prospects is that the economy does not recover in a meaningful and sustained way. Our initial observations noted optimism that GDP will bounce back earlier than a reliable and widely available vaccine is found for COVID-19. This is evident in forward rental growth rates underpinning valuations of office assets today.

Frontier is actively monitoring and assessing the relevance of the domestic and global office markets and significance for client portfolios. Our preliminary modelling to identify material impacts to the Australian office sector reflects the following:

- Historical patterns and key trends likely to meaningfully influence the sector's forward-looking attractiveness relative to other sectors. COVID-19 imposes a number of new differentiators such as work-from-home (WFH), social distancing (SODIS) in the office and possibly a return to suburban office locations.
- The likely impact of currently-observed trends on longer-term prospects for the sector, and opportunities/threats.

Figure 1: The look of future offices

Source: JLL, June 2020

Frontier sees a combination of cyclical headwinds for the office sector in the near-term, as well as emerging structural trends. Both are expected to provide uncertainty and impact returns.

Structural changes to the office sector

Much has been postulated about WFH impacts, including loss of productivity and culture, what employees miss most about the office and a new 'ecosystem' of collaboration, innovation and flexible workforce. These soft costs are challenging to quantify even though they are expected to shape the way employers value in-person office premises. What is more quantifiable is the trade-off between more office space versus less: JLL's June 2020 study suggests that real estate costs are typically around 10%-15% of people costs. Employers faced with integrating social distancing in the office will inevitably be required to balance fixed lease contracts versus flexible space in addition to new costs associated with COVID-related hygiene measures and greater technology support for WFH workforce. Increasingly, a hybrid model of CBD hub, with home-offices and co-working spaces, whether in-office or suburban locations is being proffered as an ideal solution.

Once the structural adjustments of post-COVIDs trends are overlaid on the macro environment and space market fundamentals, we expect some capital depreciation over the same period. The quantum of this depreciation is the most challenging to identify as tenants' future space requirements are largely opaque at this point.

Changing composition of indices – Australia

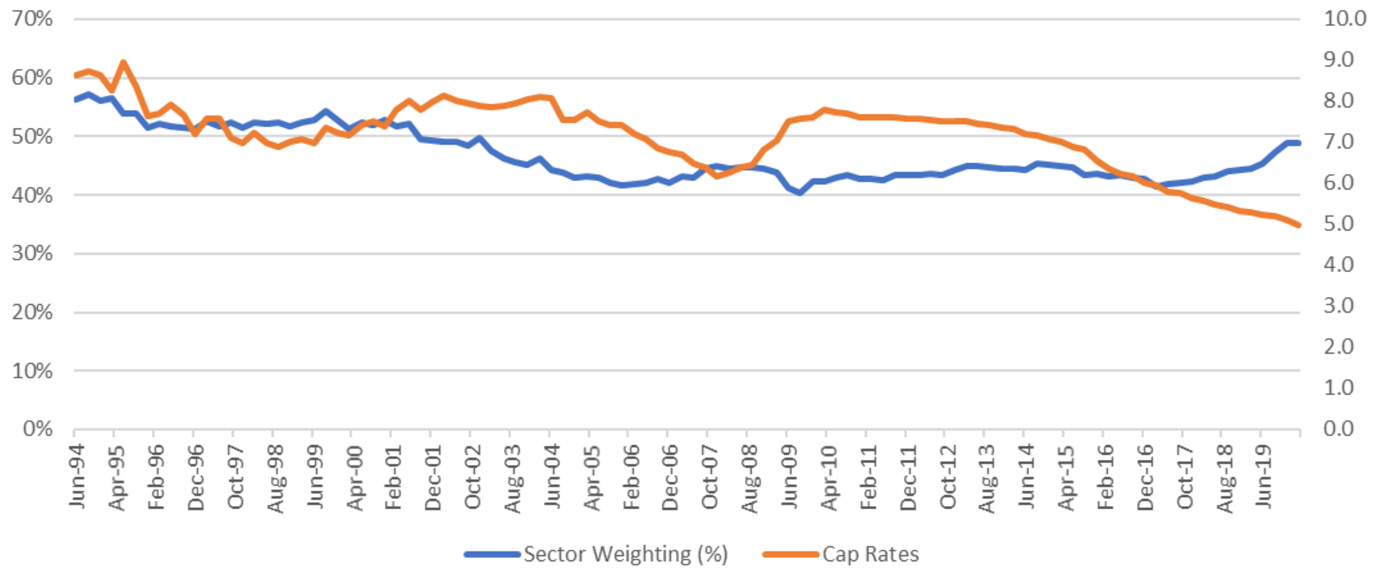
Particularly recently, the market has increased sector weighting to the office sectors. While the office sector is prone to cyclical headwinds due to economic activity, investors typically see the sector as a safe-haven for capital. In Australia, the sector has been underpinned by strong supply and long Weighted Average Lease Expiry (WALEs) leading to secure cash yields.

In recent years, the increase in sector weighting to the office sector has been a beneficiary of the structural changes in the retail sector. This has also caused cap rates to compress as investors seek prime investments with reliable returns.

While the structural changes in the office sector may be largely unknown there is no doubt the fundamentals of the sector will change. The market has a large weighting to the sector at present.

We can expect the weighting to lower substantially, however, investors may be challenged as to where they can deploy capital and rebalance their portfolios.

Chart 1: Office sector composition and cap rates



Source: The Property Council of Australia/MSCI/Frontier

Impacts on real estate investment markets

Frontier believes the real impacts of economic activity, unemployment and loss in white collar employment (WCE), who are primarily office based and drive the demand for office space, are often missed when appetite for long-dated leases are competitively pursued. In this section, we examine the historic significance of these key drivers including most recent COVID-19 data (to June 2020).

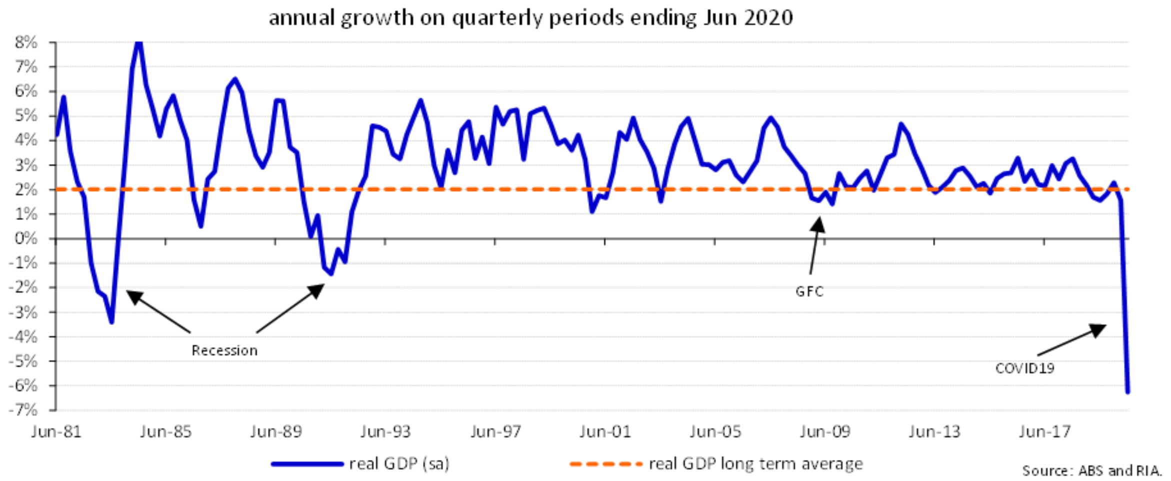
Impact of deteriorating macroeconomic environment

This key risk will adversely impact all property types but especially the office sector which is highly sensitive to changes in WCE as shown in Chart 2 and 3.

Any upside correction typically takes several quarters to flow through. Future GDP contraction and interest rate cuts (while positive for asset values), in Australia may well compromise the attractiveness of contractual rental streams even if an attractive spread persists.

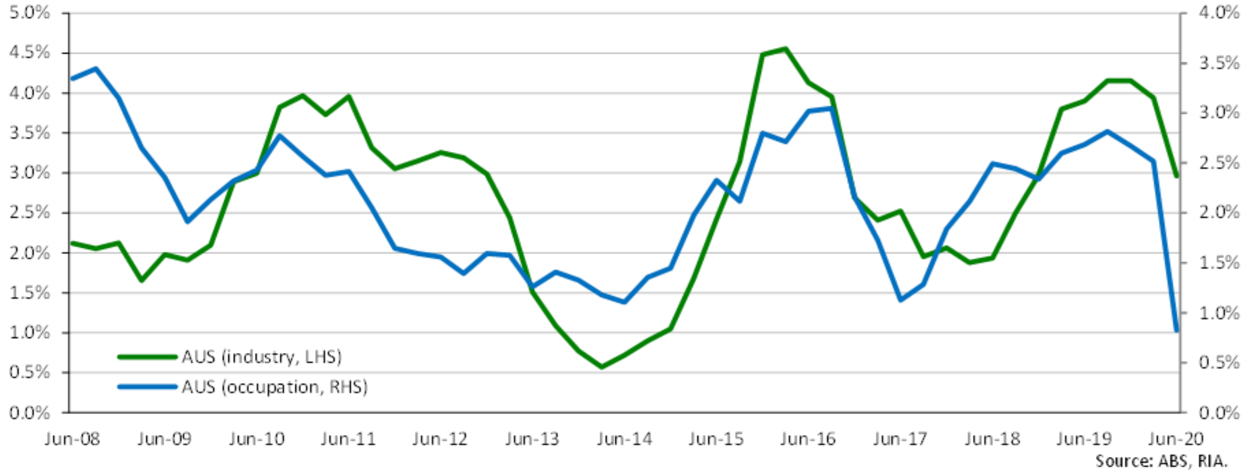
Furthermore, it is widely proven that demand for office space weakens with a downturn in WCE and this trend typically persists until there is a strong and sustainable recovery in the economy.

Chart 2: Australian macroeconomic activity



Source: Real Investment Analytics

Chart 3: WCE growth - industry v occupation annual moving average growth on quarterly periods



Source: Real Investment Analytics

Unemployment and impact on occupancy (vacancy) rate

There is a strong inverse relationship between the unemployment rate and office property occupancy rate (Chart 4). Rising unemployment historically leads to companies reducing office space requirements, which in turn results in rising vacancy rates, both in prime and secondary buildings. The consequence of this is falling rents, rising incentives and eventually declining capital values, evidenced in expanding cap rates.

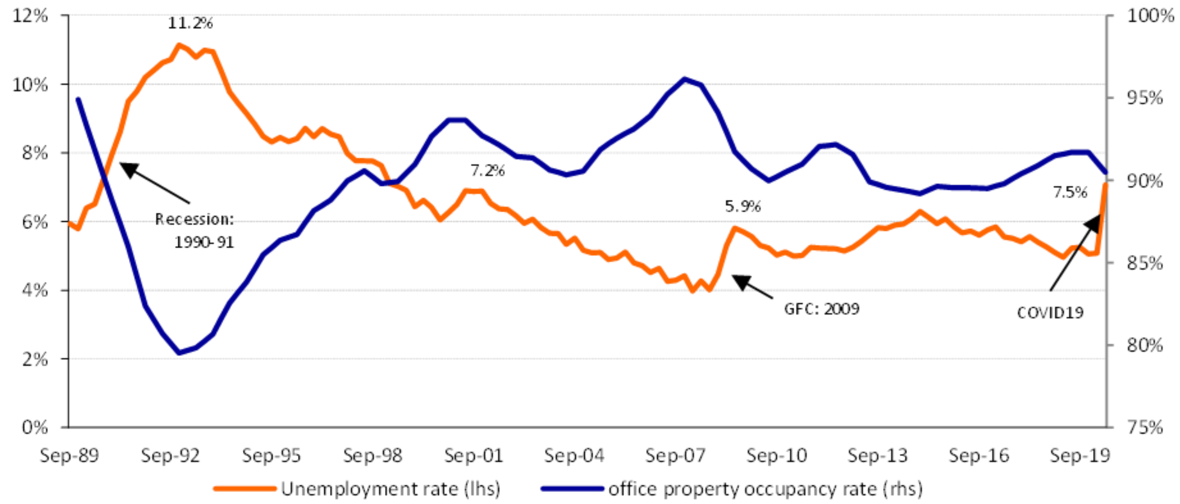
The vacancy rate or occupancy rate is effectively the net demand for space. The price a tenant is willing to pay, as demand falls, is elastic and as more space becomes available, bargaining power moves in favour of tenants who seek lower net effective rents and higher incentives.

The total vacant space, as reported by m3property, available over the next three years in the Melbourne CBD is approximately 235,000 square metres, including new and backfill space.

Backfill or shadow space

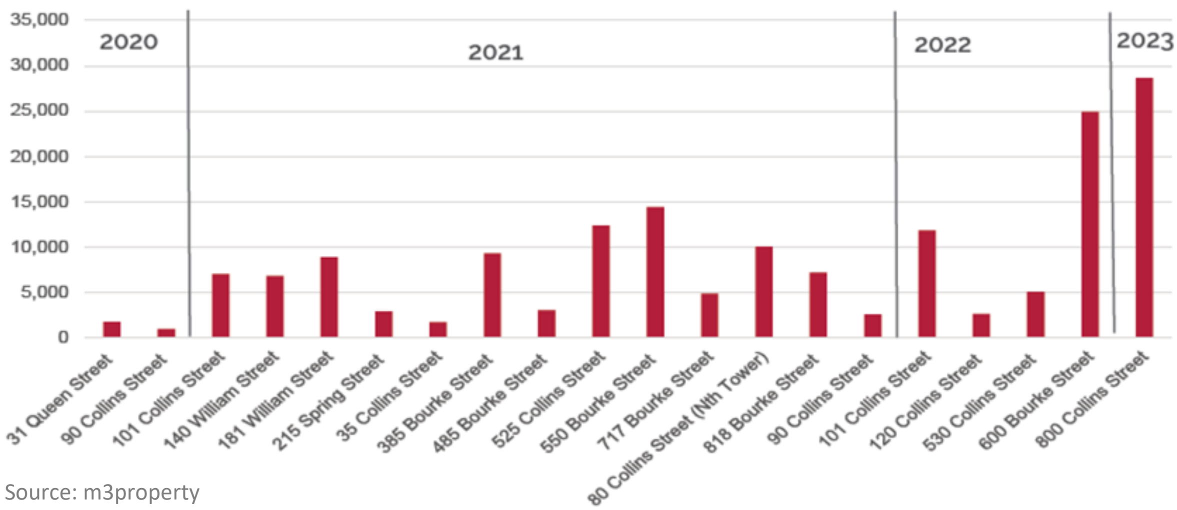
Melbourne and Sydney are forecast to have significant sublease (backfill) space over the next three years as a result of new developments coming online and pre-commitments to new buildings. Unless new tenants enter the market, the traditional domino effect of relocations from older buildings to brand new ones is expected to place enormous pressure on these secondary buildings. The forecast for Melbourne is particularly grim, as reported by m3property in Chart 5.

Chart 4: Unemployment rate versus office property occupancy rate



Source: m3property

Chart 5: Backfill space available for occupancy - Melbourne



Source: m3property

Frontier's preliminary analysis

Frontier believes the office sector is likely to undergo structural changes in the coming years. Whilst COVID-19 has undoubtedly affected the Australian economy with much of Victoria still in a hard lockdown and state boundaries largely closed, it has also accelerated key structural trends in the office property market. The two most impactful trends being working from home and de-densification. However, adoption rate for de-densification is expected to be low and slow. Businesses are seeking to reduce their cost base during an economic downturn, whilst de-densification, will increase it. Therefore, the analysis presented will address the impacts on the office sector due to the economic downturn and working from home trends.

Past downturn indicators

We can assess the impact of the current COVID-19 downturn by understanding the impact of past economic downturns on the office sector, particular looking at the early 1990s recession, the early 2000's recession and the GFC. An analysis from Yarra Capital looked at the impact of vacancy rates to capital valuations on the Sydney market.

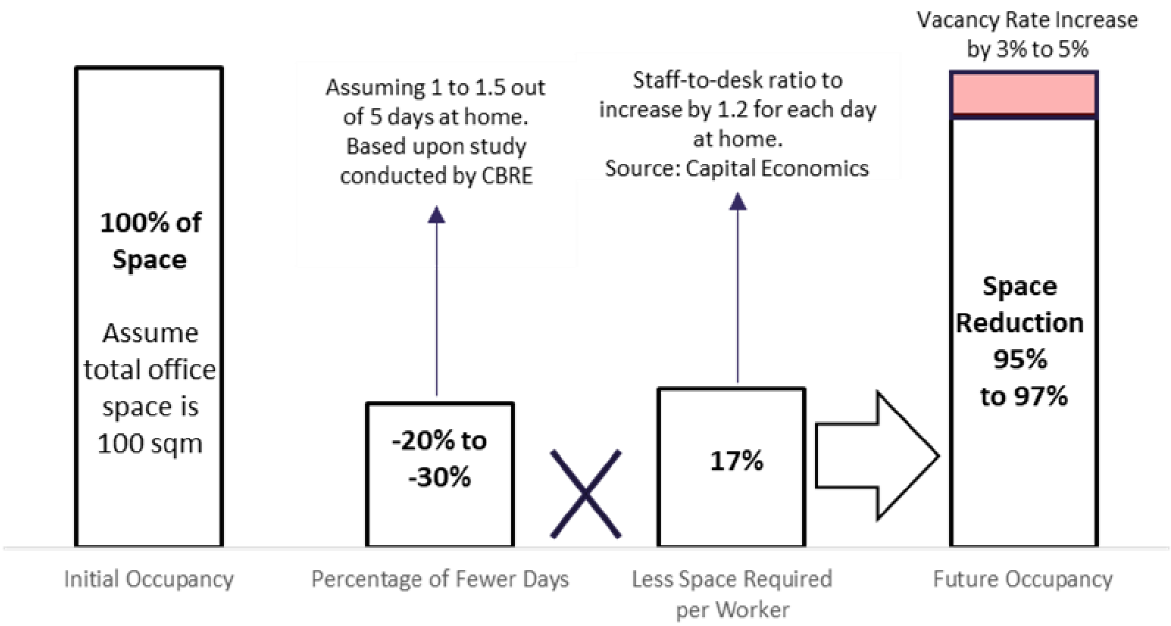
- 1% change in vacancy = ~6.6% change in net effective rents.
- 1% change in net effective rents = ~0.75% change in capital valuations.

It was suggested that the impacts on vacancy and rents can typically take up to three years before starting to recover. Whilst after periods of increasing vacancy (i.e. when the recovery then commenes), demand historically rebounded quickly, with rents following a similar trajectory.

Assessment of working from home

The impacts from WFH are likely to affect the vacancy rates of the office sector. As the office sector is typically underpinned by reasonably long lease terms, any long-term impacts on the sector due to working from home trends will play out in the next five to ten years. If we assume a large adoption rate and the technology and infrastructure is available to assist with WFH, then the analysis below assumes vacancy rates could increase by 3% to 5% in the long-term.

Chart 6: Potential office space reduction



Source: Yarra Capital, Frontier

Future impact

The office sector is already experiencing the early stages of the economic downturn with a relatively large increase in vacancy during the June quarter. For example, Melbourne CBD vacancy increased from approximately 3% to over 7%.

Table 1 outlines the impact of WFH using the framework established above. The analysis in Table 1 suggests a further decrease in the vacancy rates from WFH could translate to a decline in capital value between 17% to 25%.

The analysis highlights that a small uplift in vacancies can have a dramatic effect on capital values. However, it should be noted the analysis doesn't consider any impact from potential de-densification or other changes to the office sector (i.e. hub and spoke model).

This key risk will adversely impact all property types but especially the office sector, which is highly sensitive to changes in WCE as shown previously in Chart 3 (p. 3).

Table 1: Frontier analysis of working from home (WFH)

	WFH - Additional Vacancy	Effective Rent Growth (%)	Capital Value Growth (%)
Base Case	3%	-22%	-17%
Downside	5%	-33%	-25%
Best Case	0%	0%	0%
Average		-18%	-14%

Source: Frontier

The final word...

In assessing the office sector on a forward-looking basis, traditional supply (vacancy, construction orders) and demand metrics (white collar employment, growth in GDP and population growth) will continue to be significant inputs. Oversupply, expected in the key office markets of Sydney and Melbourne, has fueled our concern since 2019.

Given structural changes afoot in the sector, we see emerging issues such as WFH and potential return to suburban office locations, as potential disruptors accelerated by COVID-19. However, very little quantitative data is available to critically assess user demand over the next one to three years and how this key variable will impact net effective rents and ultimately capital values.

In our next instalment on the office sector, we plan to share the results of our modelling that shows our expected impact on sector returns.

We advocate caution and prefer new or incremental allocations be diverted to sectors that are less sensitive to macroeconomic drivers, such as housing and healthcare, that are needs-based and driven by strong demographic drivers. Equally, the logistics sector is a strong beneficiary of changing consumption patterns.

Overall, we prefer new or incremental allocations be diverted to sectors less sensitive to macro-economic vagaries such as housing, healthcare and strong demographic needs.