The Frontier Line

Thought leadership and insights from Frontier

Issue 186 | **November 2021**

The changing nature of the office sector in a post-pandemic world

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About us

Frontier has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice over more than $500 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Frontier's purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

Jennifer Johnstone-Kaiser

Principal Consultant, Property Leader

Jennifer joined Frontier in 2018 and 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).

Ricci Steckoll

Associate

Ricci joined Frontier as an Associate in 2020. He has responsibility for undertaking manager and investment research with a focus on property and infrastructure. Prior to joining Frontier, Ricci spent four years at Deloitte within the financial modelling team, with a predominate focus on transactions across a diverse range of sectors including, retail, property and technology. Ricci holds a Bachelors Degree of Engineering (Civil) with honours and Bachelor of Commerce (Finance) both from Monash University.

Introduction

Australian property investors with an allocation to the office sector were enjoying historically high rents and low vacancies before COVID-19 changed the world. But structural changes were already afoot as evidenced by hot-desking and on demand flexible workspace.

Frontier undertook a deep dive including regression analysis and discounted cash flow modelling which supported our initial observations: the office sector was due for a correction. Our modelling established a negative impact on the IRR from working from home (WFH) of circa 2.0%. The ensuing lockdowns and recession in 2020 compounded supply pressures on commercial office property, which is highly sensitive to economic downturns.

Australian CBD offices posted the largest reduction in demand over the year to March 2021 seen in the last decade. Tenant demand hit historical lows during 2020 and vacancies across all major cities (excluding Canberra) continue to climb.

But even before the pandemic struck, there were cyclical headwinds just around the corner. A large volume of new Sydney and Melbourne office buildings were in the pipeline and are exerting downward pressures on net effective rents while simultaneously pushing tenant incentives up to around 40%.

These forces are reshaping the sector and raising fundamental questions about its future.

The ramifications of the pandemic will continue to be felt. Uncertainties remain about whether new variants will once again prompt lockdowns or whether rising inflation will prove transitory or structural.

The pandemic has also changed the way we work.

The transition to working from home is now an entrenched part of the landscape and may prompt tenants to permanently reduce their office space. Conversely, a greater need for social distancing and a trend towards de-densification may increase demand for office space.

The outlook for office demand remains uncertain, yet there has been limited devaluation in assets to date primarily supported by strong capital market demand and economic growth.

This paper evaluates these trends and provides important context for investors considering the future role of the office sector in their property portfolios.

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The state of play

The commercial office market is the most sensitive property sector to the state of the economy and macro-economic shocks such as COVID-19.

When GDP declines, white collar unemployment tends to rise, dampening demand for office space. The result is higher vacancies, lower rents, and potentially downward pressure on capital values.

This cyclical impact, coupled with a short-term spike in unemployment and low levels of skilled migration thanks to the pandemic, has resulted in lower net effective rents (NER) and lower total returns.

NERs have continued to fall across all major Australian markets, underpinned by rising incentives to combat a soft market.

The Melbourne and Sydney CBD markets have been hit the hardest by falling rents, which have anecdotally declined by up to 18%.

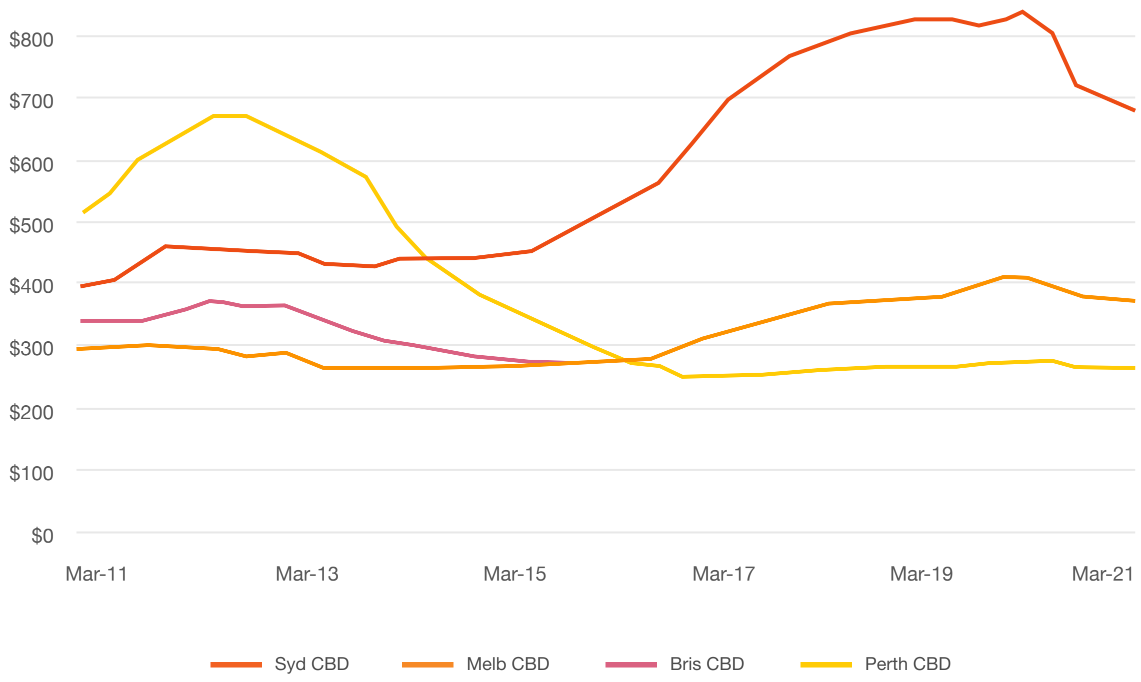
Meanwhile tenant demand hit historical lows during 2020. Vacancies across all major cities, except Canberra, are still climbing.

Over the first half of 2021 there has been a flight to better quality assets, with vacancies falling marginally across premium grade buildings in Sydney, Melbourne and Perth.

While NERs and vacancies are likely to continue to soften, the rate of decline appears to have slowed.

Sublease space is above the historical average for the CBD. However, the first half of 2021 recorded a slight fall in CBD sublease availability across Australia.

Chart 1: Net effective rents across key Australian markets



Source: JLL Research, Dexus Research

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There are some positive signs.

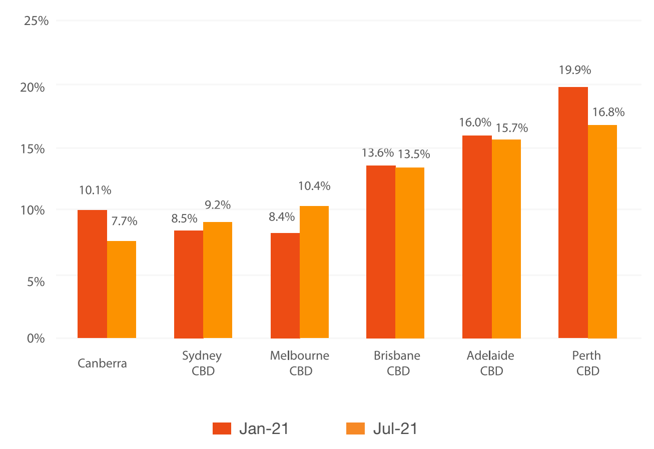
As Australian economic conditions and confidence improved in the wake of the pandemic, the rate of negative net absorption (the sum of square feet physically occupied, minus the sum of square feet that became physically vacant) began to reduce over the first half of 2021.

Sydney posted its first positive net absorption in five quarters, while Perth and Brisbane also improved. The Melbourne market is still subdued but has improved quarter-on-quarter.

However, vacancies will still be impacted by the large supply pipeline over the next few years. Despite this, investment managers continue to report positive lease uptake on long-term leases for well located, prime office assets. Frontier's view is that hidden costs are less transparent in reported face rents.

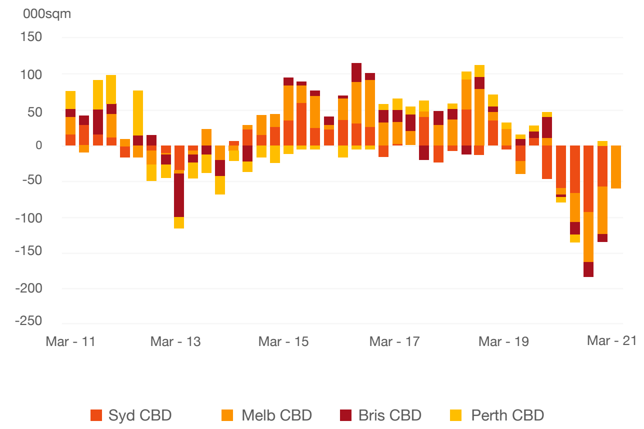
Chart 2: Australian CBD office vacancy

CBD vacancy change - six months to July 2021



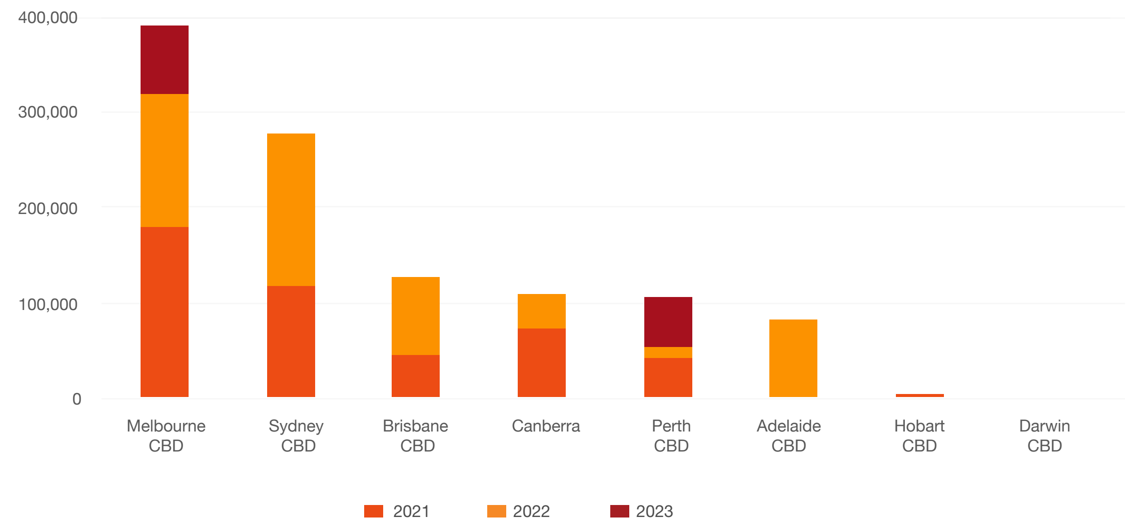
Source: Property Council of Australia

Chart 3: Secondary market volume and bid/ask spreads



Source: ABS, NAB, Bloomberg, Dexus Research

Chart 4: Future supply of CBD markets (2021-2023)



% of current stock	8%	5.5%	5.5%	4.6%	5.8%	5.5%	0.9%	0.0%
Pre-commitment	35.3%	55.3%	53.4%	53.5%	40.2%	22.9%	0.0%	0.0%

Source: Property Council of Australia

Office sector and cap rates remain attractive to offshore investors

Despite falling market rents, Australian prime office yields have remained stable at around 4.6% - 4.7%.

The spread between office and bond yields remains attractive for European and Asian investors, who have continued buying properties in late 2020 and early 2021. Overall transaction volumes in 2021 have slowly started to pick up from a low base in 2020, however have stagnated in recent quarters.

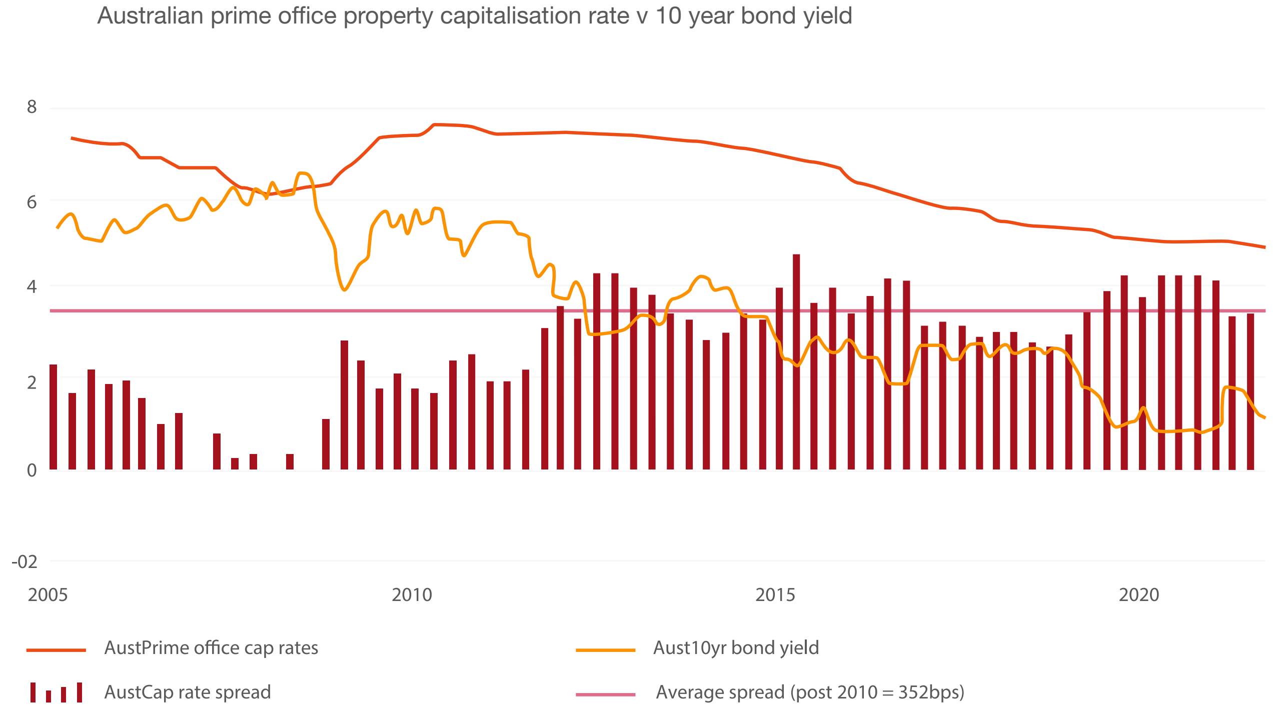
Foreign investment accounted for almost half (45%) of the more than $2.8 billion in transactions over the first quarter of 2021.

Two of these properties were prime assets in Sydney: the South Tower at 39 Martin Place (bought by Investa and Manulife), and 1 Bligh Street (a one-third stake bought by Mercatus and Dexus).

As Australia's international borders continue to open post-pandemic, allowing for more capital inflows, this may further support tightening of cap rates.

The risk to the sector is rising bond yields and inflation. Whether the recent rise in inflation proves transitory in the wake of the pandemic remains a key question.

Chart 5: Bond rates and Australian CBD prime office yields



Source: Refinitive Datastream

Working from home and de-densification: the great unknowns

The pandemic has accelerated two key trends: working from home (WFH) and de-densification.

The greater prevalence of WFH is likely to shift the focus of offices towards greater collaboration, culture and communication. The office will become a space to create ideas and to build a sense of camaraderie between colleagues.

Increasing demand for more collaborative space for on-demand meeting rooms, café style lounges and health and fitness amenities come at a price.

The negative demand on office space demand from WFH will likely be partially offset by greater need for collaborative areas and potential social distancing requirements.

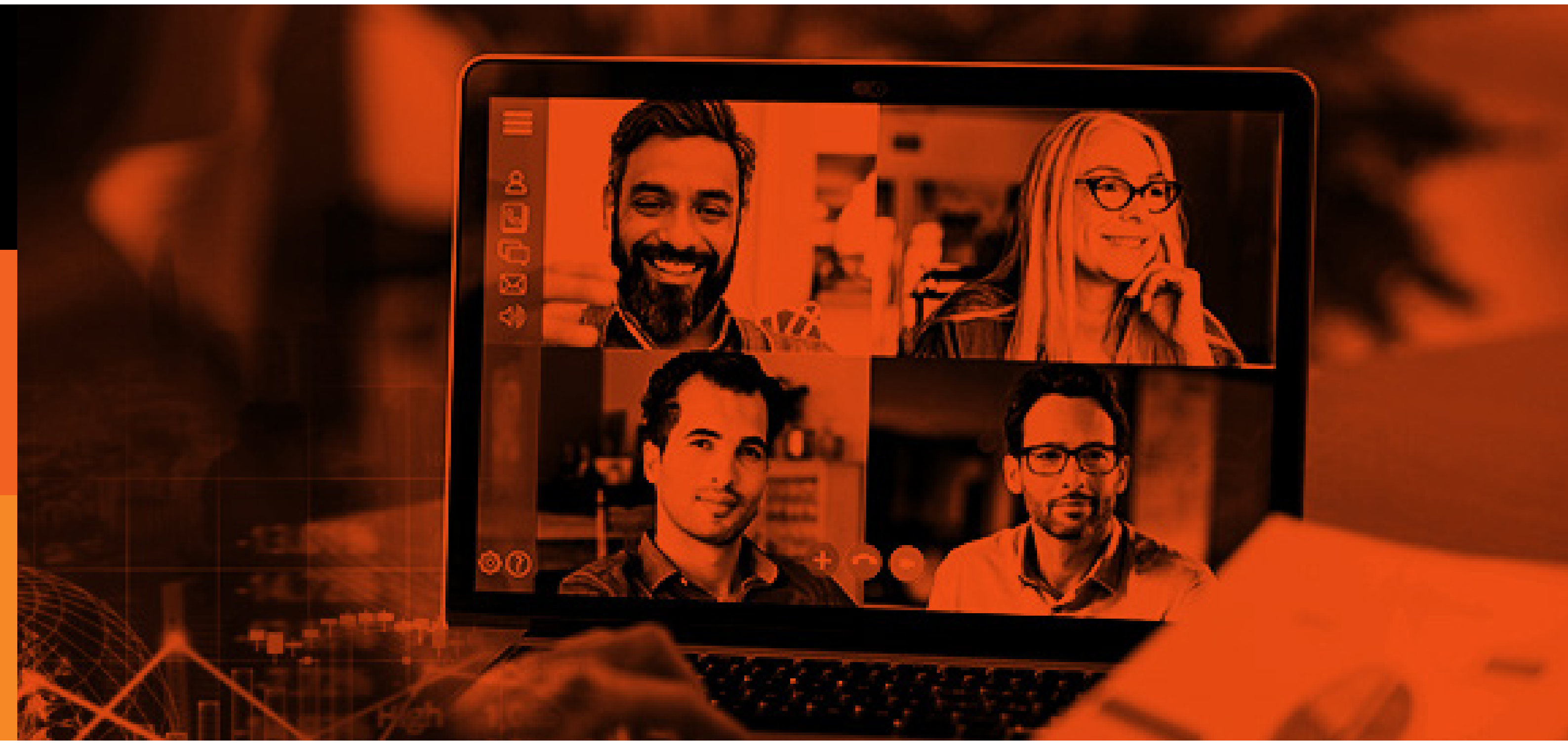
Strong economic and white-collar jobs growth may also offset these impacts over the longer-term.

There are some signs that businesses may have become more comfortable with this trend relative to their office space.

While global tech companies Amazon, Facebook, Google and Atlassian have an inherently mobile workforce, their businesses are continuing to expand their office footprints. This is evident from Atlassian's new headquarters adjacent to Central Place Sydney being developed by Dexus, within the State Government-led Tech Central precinct. The 40-storey tower will target 6-star NABERS Energy and 6-star Green Star design ratings, focused on occupant wellbeing with each four-storey section to be known as 'habitats', that will have naturally ventilated areas throughout. These amenities are proving to be highly attractive to tenants and employers alike.

Meanwhile, the proportion of CEOs who said they were considering downsizing their office space has reduced from 69% in August 2020 to 17% in March 2021, according to a recent KPMG CEO Outlook Pulse survey.

Trends	Impact on demand
Working from home	↓
De-densification	↑



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Of more concern, valuers and fund managers are not yet fully incorporating the WFH trend into their valuations. They point to long term lease covenants and tenants' obligations to meet those even as flex demands rise. How much of that space will be surrendered on renewal is difficult for any fund manager or valuer to assess at this point in time.

The vacancy rate across Frontier's clients' portfolios is low at circa 5%, with a weighted average lease expiry (WALE) of 5.4 years, given that our clients primarily hold prime office assets.

The reasonable WALE in portfolios should help reduce the impact of falling market rents on valuations. However, portfolio vacancy could increase as leases expire in coming years, putting pressure on income.

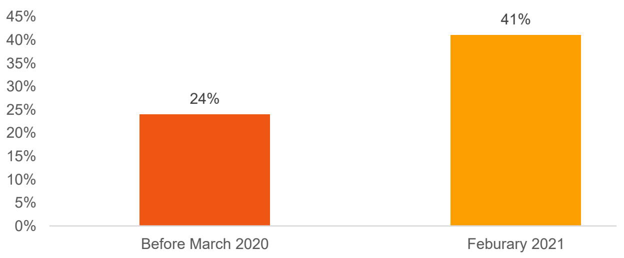
Investa has estimated that increased workplace flexibility will decrease demand for Australian office space by 20% (or one day a week at home) although increased CBD office workspace and a strong economic recovery would result in modest positive net absorption.

QIC has forecast that working from home could see a fall in Australian demand of 15%, however de-densification would increase demand for space by 10%.

Two factors are likely to drive an increase in WFH: willingness from employees and employers, and an ability to successfully implement a hybrid model including WFH.

In Australia, the number of workers regularly working from home (at least one day per week) increased from 24% pre-pandemic to 41%. Numerous projections suggest WFH will double from pre-COVID-19 levels.

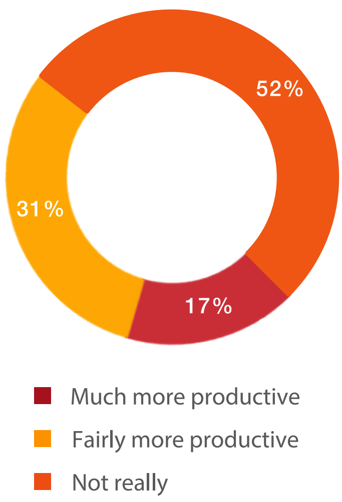
Chart 6: Percentage of workers WFH (at least one day a week)



Source: ABS

Several surveys estimate that between 60-85% of employees want some level of WFH whereas employers typically have a mixed response to working from home driven by questions around productivity.

Survey of employees on productivity



Only 48% felt more productive at home

To what extent did you feel more productive when working from home (in comparison with working from the office)?
Sample size of 2115 people who had to work from home.

Source: JLL

De-densification trend continues

Social distancing requirements due to the pandemic has put office densification in the spotlight. However, even before COVID-19, studies had shown that over-densification could be detrimental to employee productivity.

Workplace density almost doubled between 1992 and 2015 as businesses allocated less space to each employee (or their workstation) to cut costs.

It is likely that we have reached "peak" density, with a slight easing in workspace ratios already seen in the US.

With Australian office markets at close to 70% capacity, many offices would need to be redesigned to meet distancing constraints.

De-densification could be a positive for property owners because it would increase demand for space, potentially offsetting lower demand thanks to WFH.

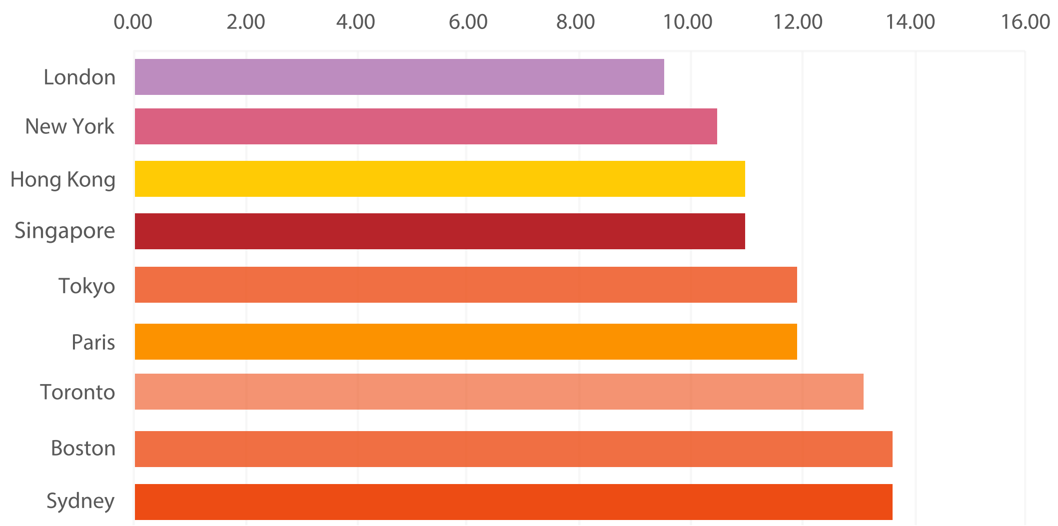
There are a number of differing views regarding the optimum space per worker. DWS estimates that about half of office tenants will require additional space as offices with less than ~14 square metres per person become the norm. CBRE believes that space per worker in the US will not change over the next five years. Meanwhile, JLL does not expect workplace design to be driven by legal requirements such as social distancing post-pandemic.

Any impact of de-densification is likely to differ by industry and geography. Less dense office sectors such as legal and government or locations such as San Francisco and Melbourne are likely to be less supportive than those which are dense such as co-working spaces and consulting or locations such as Tokyo and London.

However, Frontier does not believe the de-densification argument will meaningfully impact office demand with large numbers of white-collar employees already working from home and the availability of flexible space.

Overall, we believe the net impact of remote work and de-densification effects will, at best, be modestly negative on global office demand.

Chart 7: Work place density - square metres per desk



Source: UBS, Cushman and Wakefield

The final word

Frontier expects the office sector to deliver positive returns over the coming decade, albeit much lower than the sector did over the previous ten years.

Short-term conditions will keep returns from the sector subdued over the next several years as working from home effects unwind.

Foreign and domestic capital has supported Australian office valuations, attracted by long lease convenants and stable cash flows particularly from CBD premium assets.

A myriad of factors such as WFH, de-densification and over-supply makes it difficult to precisely quantify the rebasing of the sector, particularly as their impacts will differ by industry, geography and grade.

Frontier believes the net impact of remote work and de-densification effects will be modestly negative on global office demand. If employers allow workers to work more flexibly (one to two days a week out of the office) and each worker is still assigned a desk, the need to further reduce space is unlikely. However, the temptation for employers to re-assess fixed lease costs is arguably strong nothwithstanding all of the cultural arguments in favour of in-office presence.

Strong economic and white-collar jobs growth may offset these negative impacts over the long-term.

If interest rates remain lower for longer, it will provide support to office capitalisation rates, although this may be offset by rising inflation expectations and (possibly) bond yields.

After a period of readjustment, the office sector will still provide suitable returns and therefore maintaining an allocation to the sector will provide reasonable diversification over time.

Want to learn more?

If you would like to find out more about the opportunities and considerations for investing in real estate, please reach out to Frontier to discuss how we can assist you further in this space.

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