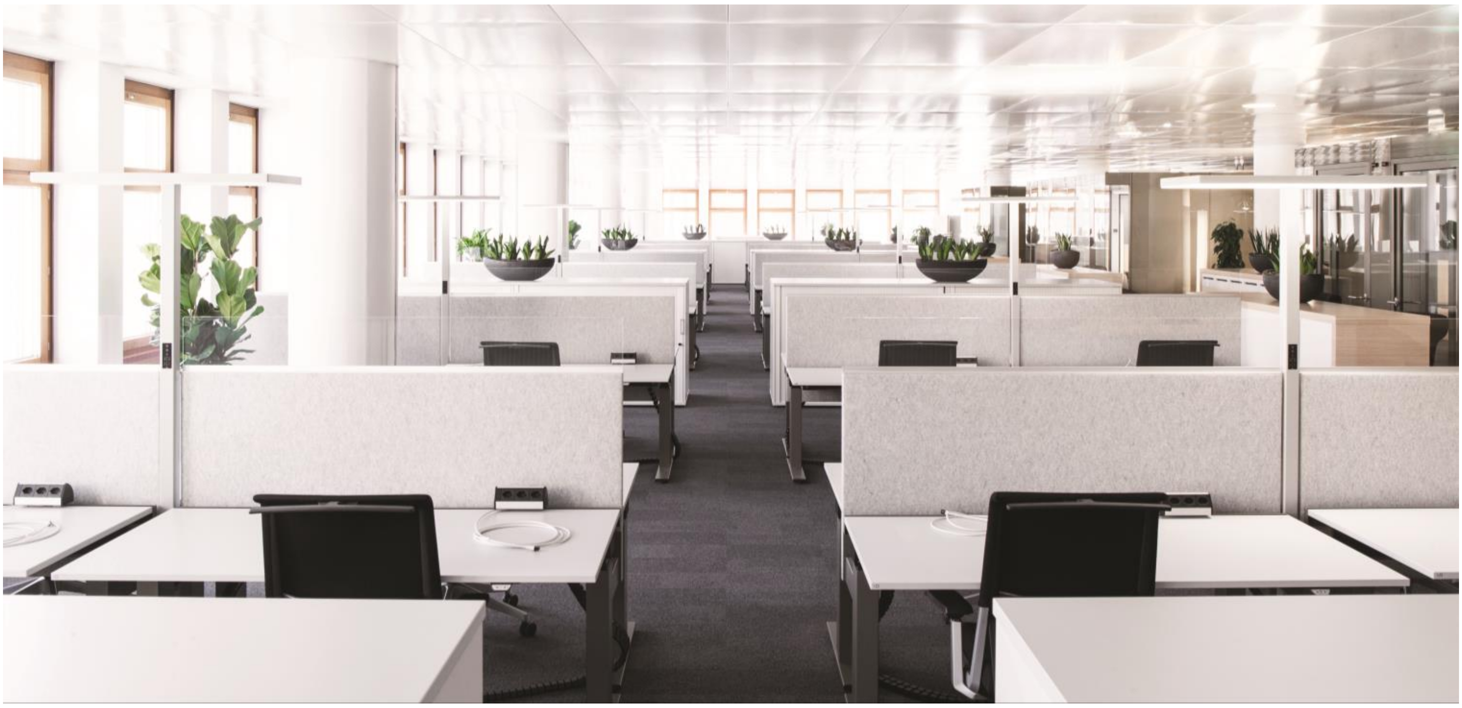
Research Blast

COVID-19 European Office Markets Series, Edition 1 – April 2020



New occupational demand will drop away significantly this year. The question is will the market recover in 2021?

Disruption to office occupiers is not as significant as other sectors. But a protracted downturn will hurt revenue streams and lead to a spike in defaults.

Serviced office providers are, however, facing very immediate impacts to their cash flows. Will they be able to survive long enough to benefit from any structural shifts longer term?

We are in uncharted territory

Within a matter of weeks, COVID-19 has caused an unprecedented level of disruption to all asset classes. Office real estate markets are by no means immune to this, but due to the illiquid nature of the asset class it will be several months, if not longer, before the true impact is fully reported through data. Throughout this series, we will use the limited evidence currently available to help paint the short and longer-term pictures for office occupiers and their landlords.

The initial focus of the series will be on the most pressing issue today, namely the occupiers. We will then look at implications for supply and rental growth (or decline), investments, and longer-term opportunities and structural change we believe will be born out of this crisis.

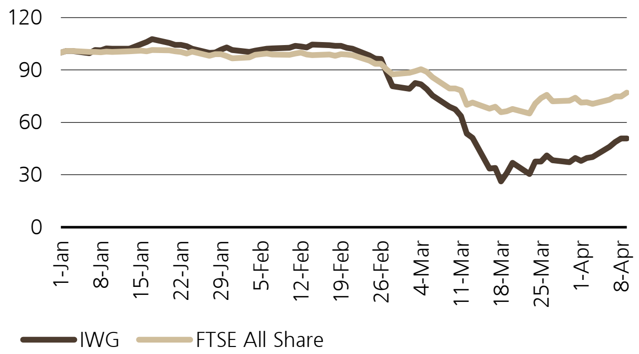
But right now, landlords are focused on dealing with the immediate fallout from the lockdown and ensuing financial challenges. To begin on a positive note, the short-term problems facing the office sector are currently nowhere near as severe as those affecting the retail and leisure sectors. Most office occupiers are able to continue running their businesses (albeit with some significant disruption), rather than contending with the complete shutdown of revenue which is the case in other areas of the economy. That said, there is one sector of the market directly exposed to the immediate impacts of COVID-19, and we address this area first.

Serviced offices

We have long made the case – while accepting the trends supporting the growth in these operators – that the risks associated with the underlying business model need to be factored into the value of the real estate they occupy (refer back to our white paper on Serviced Occupiers Nov-19).

The true test of this business model was always going to come when occupier markets faced a real downturn in demand, as is the case now. And what makes this situation even more challenging (in addition to the economic slowdown) are the social distancing measures impacting most major global office markets, which in effect render these centers unusable. Equity markets moved quickly to price in this risk, and despite a slight recovery IWG's share price currently trades at 50% below its pre COVID-19 level (vs. a market decline of circa one quarter), while WeWork's corporate bond currently yields above 30%.

Chart 1: IWG and FTSE All Share price index (1 Jan=100)



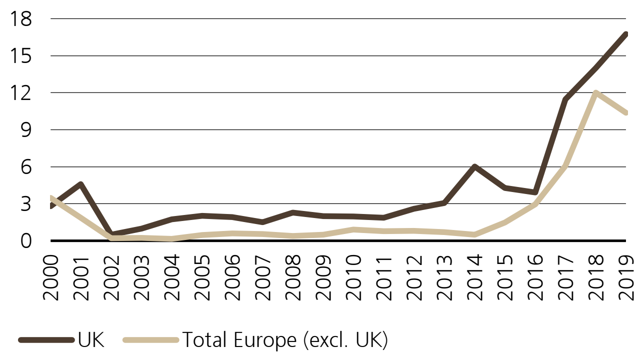
Source: Datastream; 9 April 2020

Unsurprisingly, both operators have approached their landlords to negotiate some form of relief from the current short fall in their cash flows. Time will only tell whether these operators, and indeed the many other smaller outfits which have sprung up over recent years, can weather the storm. This will largely depend upon how accommodating their landlords and investors are, and how long the lockdown period lasts for in their key markets. But the impact to their memberships will be pronounced on both ends of the scale. Many of the freelance and SME occupiers may struggle to survive this period. And even if they are able to do so, they are likely to be very cautious on costs coming out the other side, so could resist going back into expensive serviced office space in the short term. With their larger corporate tenants (a key growth area for the serviced office model), we expect to see consolidation in the coming months as firms reduce their headcount in response to the economic environment. The easiest workspace for them to vacate is, by definition, the flexible space.

The counter argument has always been that in a downturn, occupiers will actually seek more flexible space. This may be true over the longer term, but the inherent flaw in this argument is that at the point of downturn, most corporates are still tied into traditional leases which extend past the height of the downturn. As these are expensive to break, there simply is not the option to switch from one to the other.

To protect short-term cash flow, the only option is to vacate the flexible space over the coming months, and it has even been reported that many tenants in serviced offices have simply cancelled their payments. It may be that in the coming years there is a growing shift towards corporates occupying more flex space as their traditional leases expire. The key question, however, is how many of the serviced office operators will survive this downturn to benefit from any potential upside from a longer-term structural shift.

Chart 2: Serviced offices as % of total demand



Source: PMA; Spring 2020

Traditional occupiers

The short-flow cash flow of most traditional office occupiers should be relatively resistant to the COVID-19 disruption, and requests for rent relief have been significant lower than other sectors. However, all businesses will be affected by the economic disruption. Revenue streams will be damaged (with significant variation across sectors and companies), but ultimately that negative impact on cash flow will be passed through to default risk on rent payments further down the line. Liquid markets have quickly priced this in, and while AAA and government bond yields have been defensive (partly helped by monetary policy), weaker credit ratings have seen yields move out significantly in both the UK and eurozone.

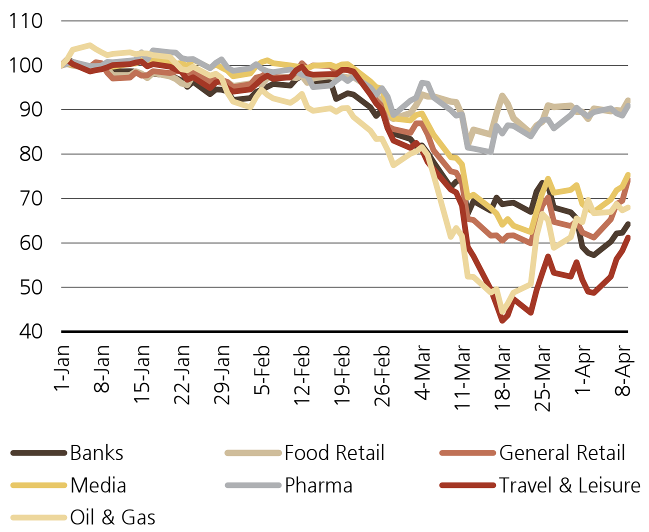
The initial pressure points are likely to be felt among SMEs, who typically have lower cash reserves and may find it increasingly challenging to access credit – although government schemes should provide at least some breathing room. And with many of these companies opting to take space in serviced offices over recent years, the negative the impact on the mainstream market should be partly cushioned.

For larger corporates, the initial impact will be a general loss of new transactional activity. Some deals which originated pre COVID-19 are progressing, but new transactions and growth plans are on hold. Companies will be reluctant to commit to the capex and risks of leasing new office space without knowing how long and severe the impact on their business will be. Take-up will fall away significantly in 2020, and while there is likely to be a recovery in 2021 if the downturn is V-shaped as pent up demand is released back to the market, under a U-shaped downturn corporates are likely to remain cautious and renegotiate and downsize existing space (as we saw in the aftermath of the GFC).

Sector level impact

We can also start to make some assumptions on which sectors are going to be most exposed to the impacts of COVID-19. In turn, this will give us an indication of the markets and sub-markets, which may face the biggest demand shock in the short term.

Chart 3: FTSE 350 Index by sector (1 Jan = 100)



Source: Datastream; 9 April 2020

Indications from equity markets are intuitive and broadly follow the direct impact of the virus – retail and travel are clearly badly affected, while pharmaceutical and food retailers are the most resilient. However, it is important to note that these occupiers tend to locate their office functions in out-of-town, or secondary market locations, and so the impact may be disproportionately felt in certain locations. This is particularly the case if an occupier is a key employer in a relatively small office market. Examples here would be the British Airways HQ at Heathrow Airport and the Airbus HQ in Toulouse. On the flip side pharmaceutical companies also tend to cluster around research hubs – Cambridge (UK) would be such an example of a location which may prove resilient in the short term.

Focusing more on city centre occupiers, we consider the finance sector to be relatively exposed. European banks were already challenged by regulatory burdens and record low interest rates. The latter is only likely to persist for longer now. But specifically in terms of revenue, the dramatic decline in asset prices will pass through into reduced fees on all funds which are measured off an AuM basis, while redemptions will be adding further downward pressure on revenues. M&A activity and IPO launches are also going to be on hold – causing a further drag on revenue – until there is some degree of normalization.

For technology companies it is more of a mixed bag. This has been a key area of growth for many European markets in recent years, and that growth is likely to tail off for the short term at least. There has been a significant growth in demand for certain types of technology (anything related to home working and media entertainment for example); however, the social distancing measures will limit the capacity for new innovations and collaboration. Venture capital flows in start-ups will be disrupted and M&A is also likely to be very slow. But the risk of job losses and consolidation is less significant than other sectors. Revenue streams for digital companies should remain relatively stable due to the subscription nature of many of their services. And the technology sector is probably the main area where staff hoarding (the concept of companies keeping staff on during a downturn due to tight labor markets) may protect jobs in the short term.

As is usually the case during a downturn, the most defensive sectors are likely to be business services – accountants, lawyers and consultants – who will be in high demand as this crisis unfolds. And the public sector may actually see a short-term expansion in their workforce, however, this will predominantly be in back-office locations where these functions have been shifted to over the past few decades.

We remain hopeful that this is a V-shaped downturn and that most office occupier are able to weather the storm and keep the majority of their staff on the payroll. And if this is the case, there are several reasons why this slowdown should not be as damaging as either the dot com crash or the GFC. Previous downturns were actually triggered by endemic issues within sectors which were prominent office occupiers (finance and technology companies). This however is an external challenge, and European governments have already taken more aggressive action to combat and protect jobs than during the GFC. The level of over-hiring in the run up to this downturn has also been far less prominent than previously. Indeed, many corporates have spent much of the past decade consolidating their workforce after the excesses of the financial crisis.

Short-term demand will be very weak, but this should at least partly be recovered in 2021 under this scenario. But sadly we cannot deny that the risks lie heavily to the downside. The disruption can only continue for a relatively short amount of time before we start to see significant office-based job losses. Reportedly in the UK, over 50% of firms are furloughing workers. With the huge financial cost of this program, and similar ones across Europe, how long can this lifeline keep jobs alive for if lockdowns persist throughout the summer?

Unfortunately, if things are not able to return to normal, the damage done to corporate office occupiers may be even more severe than the financial crisis. We are likely to see a spike in insolvencies, while many companies which do survive will need to trim their workforce to balance out lower revenues. This would lead to an abundance of overcapacity, and over time, further space being returned to the market as lease events allow. The capacity for a recovery in net absorption, would be pushed much further down the line. This is all a bit bleak, but one very important factor is the supply side, which is generally coming from a very low base and will be key in supporting the market over the short term. This topic, and our anticipated impact on rents, will be the subject of our next paper.

Real Estate & Private Markets, Research & Strategy – Europe

Gunnar Herm
Zachary Gauge
Sean Rymell

For more information, please contact:

UBS Asset Management
Real Estate & Private Markets (REPM)
Research & Strategy – UK

Zachary Gauge
+44-20-7901 5534
zachary.gauge@ubs.com

Follow us on LinkedIn

To visit our research platform, scan me!

www.ubs.com/repm-research