UBS Asset Management

The office of the future vs. future of the office

A Q&A with Zachary Gauge

What do you make of some of the recent statements made by CEOs, suggesting that working from home may be here to stay?

On the face of it, these statements are very alarming for European office markets. But we have a few reasons to be somewhat sceptical about the extent of these claims.

Firstly, most office-based companies rely on human capital to produce revenue, and in sectors where competition for staff is intense, the office has become a key tool in attracting and retaining skilled employees. Huge investments have been made by tenants to create working hubs all focused around the concept of interaction and collaboration between their staff. The office environment has shifted significantly from bland, desk-based structures to an environment with a much greater focus on staff wellness, company branding and breakout spaces to encourage greater interactions between teams. Are these factors simply not relevant anymore? We think, over time, the lack of interaction and ability to easily meet colleagues and clients will refocus attention on these core functions of office space, which were recognised to be key in supporting revenue before the virus outbreak.

That follows on to the second big question, which is, if the office isn't entirely necessary, why has it taken a global pandemic to fast-forward a major structural shift in workplace strategy? The technology for remote working has been available for decades. In theory, the strategies currently being talked about should have been implemented years ago.

The reality is that corporate media statements, particularly regarding real estate strategy, often need to be taken with a pinch of salt. It should be remembered that the home-working conditions of the individuals making these statements are likely to be very different from the vast majority of their employees, particularly younger staff. Many do not have the luxury of a home office and, in the most expensive cities, such as London, where many young people live in shared accommodation, home working can be a challenge. The need to provide a desk for those employees who need one will not disappear. Making bold statements regarding future workplace strategy is a win-win in the current environment. It demonstrates to shareholders a willingness to cut costs and offers flexibility to employees. However, following through with such measures is often a very different reality.

So do you see any long-term impact due to COVID-19?

Yes, but it's important to see it as an accelerator of existing trends, rather than a game changer within its own right. And, numerous surveys that have been done since the virus outbreak do indicate that there is a willingness from both the employer and employee to facilitate more flexible working going forward.

However, the extent to which this will really impact the office market is highly debatable and subjective. Our view is that the vast majority of staff will remain office-based but will be given a greater degree of flexibility to decide on which days they come into the office. In this sense, the only significant shift that COVID-19 has delivered is a breakdown of cultural resistance to home working. Indeed, many large corporates had embraced this type of flexibility long before the virus outbreak.

So on a very simplistic level, if the trend of flexible working does accelerate and staff spend more days working from home, there is a net reduction in demand for office space. But translating this into an occupational strategy is not so straightforward. One of the key challenges that has been faced by corporates who have already implemented such policies is rightsizing their office for the number of staff coming into the office on any given day. Typically, when given a choice, most staff tend to work from home on Mondays and Fridays, which creates over- or underutilisation of space during the week. A further challenge in the short term will be that hot desking will be restricted. This may implicate a vast number of unutilised desks on many days of the year, limiting any cost-saving potential of increased home working, under the traditional leasing model.

How do you expect this will impact occupier demands?

One of the key impacts we expect to see post-COVID is an increasing desire for flexibility. Again, this is not at all a new trend — the massive expansion of serviced offices over the past few years has already demonstrated this demand. But we do expect corporates to be prepared to pay an increasing premium for space where they would have the ability to flex in and out of workspace as required on an almost daily basis. This does not necessarily mean moving completely from a traditional lease to serviced office space. But, having some proportion of flexible space within a building that, as part of a traditional lease, the occupier can use as flexible overflow space will attract an increasing premium. This can be leased directly to a serviced-office provider, however, with trust breaking down with the main operators, we expect landlords of larger assets to increasingly offer space on their own balance sheet. The cashflow risk may be higher, but it provides an opportunity to develop a bespoke service to their tenants and combine access to flexible space within the agreement of any traditional leases in the building.

In general terms, most office-based businesses have been able to achieve a reasonable level of business continuity through home working. What is far more challenging, however, is implementing any new initiatives to grow business, without being able to meet either colleagues or potential clients in person. The post-COVID-19 office is going to become increasingly focused towards supporting the latter. In essence, if day-to-day functional desk-based work can be done remotely, making a journey into an office needs to add additional value. This typically is achieved through interactions. So the focus of the space provided will need to shift away from physical workspace, and more towards interactive and collaborative spaces, meeting rooms and company branding.

This will accelerate the polarisation to better quality buildings, which have these value-add attributes. The attraction of leasing bland and functional desk-based office units will have a decreasing relevance going forward. And, although we are uncertain on the future direction of the virus, we expect that even if a vaccine or treatment is found, the memory of the pandemic will maintain a focus on wellbeing features, such as advanced heating, ventilation and air conditioning.

Do you expect secondary locations to struggle to attract demand?

Absolutely. Again it is the issue that functional office locations, typically business parks or weaker secondary city locations, will offer very little to enhance the experience of coming into the office. Without that additional value, in terms of both amenities but also proximity to other companies and clients, the value of the workspace element of the office building will diminish.

It is not just proximity to amenities and clients that we think will polarise performance between central and suburban office space. The expected increase in flexible working could actually have more profound impacts on the residential market, particularly in the larger cities. The length of commute which an employee may be prepared to make if they are only required to be in the office on a few days of the week, rather than five, could increase significantly. So the radius that employees live away from the city centre should increase over time. But the office needs to remain accessible for the days that staff do commute into the office. Essentially this means being located close to the main central public transport hubs to enable the office to be accessible from the widest commutable locations. This gives the company the largest pool of talent to recruit from, and a higher probability of retention. The challenge of non-central suburban locations is that, whilst they are extremely convenient for staff living in that part of the city, it is the opposite for employees living elsewhere. In addition, it limits the capacity for further decentralised living to make the most of less frequent trips into the office.

Given the structural shifts in retail due to the shift to e-commerce, could the office sector experience similar challenges?

For the weaker office locations and assets that fail to move away from a functional workspace environment, there is likely to be accelerating depreciation. But there is one fundamental key difference between the retail and office sectors, which should mitigate the negative impact on the overall market. In the past, office buildings have proved to be far more adaptable than retail to changing demand trends. 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 utilised as office space, but has since been converted into alternative uses, bringing overall vacancy rates down. City-centre office buildings are even more defensive, as often residential capital values will be higher than the office value, which encourages conversions even during periods of strong office demand. London's West End office market, for example, has lost 367,000 square metres of net office space between 2013 and 2019 due to these conversions (PMA, July 2020).

Even with rents falling, retail floor space remains by some distance the highest capital-value real estate. And, this makes conversion of large-scale retail parks and shopping centres economically unviable in the vast majority of situations. As e-commerce has eroded the volume of floor space 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-centre 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. Unless demand for the office dies completely, we don't envisage the same fate for the sector that the retail sector is undergoing.

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Zachary Gauge is a research analyst for Real Estate UK, a business which forms part of Real Estate & Private Markets within UBS Asset Management. Gauge joined UBS Asset Management's Real Estate Research & Strategy team in December 2014. His main role is to help the European real estate teams identify risks and opportunities in office markets with a particular focus on the UK, using a top-down macroeconomic approach. Gauge also delivers regular research-based views on the market to the internal fund management teams and external clients in both written and verbal form, and in addition, contributes to the biannual European commercial property forecasts, the development of fund strategies, new products, and supports ongoing marketing and capital raising efforts.

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