Office real estate: Not death but change

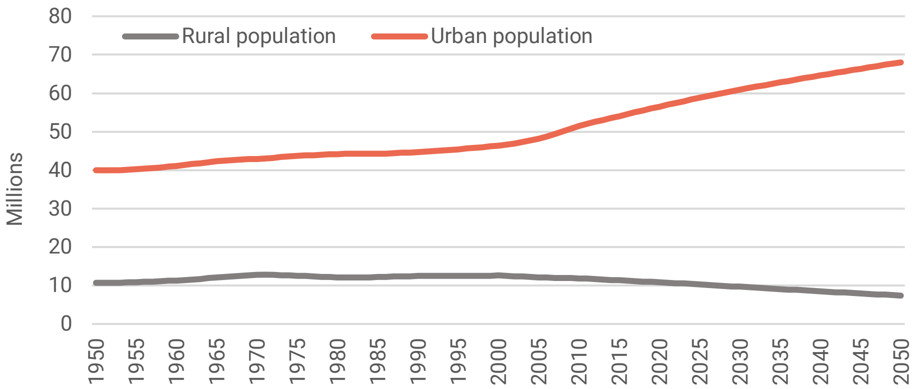
"The reports of my death are greatly exaggerated" – Mark Twain

City life signifies what is often a sought-after lifestyle, particularly for the younger generation. The bright lights and faster pace of life in bustling hubs, with ample opportunities for exciting careers and entertainment has attracted younger people to migrate to cities since time began.

For employers too, the attraction of large cities, with diverse populations and solid transport infrastructure, makes city-centre headquarters a clear advantage when looking to attract the best talent.

The pace of urbanisation, a trend that can be traced back to the growth of factories in the Industrial Revolution, looks set to continue long-term – despite the temporary setback caused by the forced 'stay home' policies sparked by Covid-19. Better wages and career opportunities have encouraged people to continuously migrate to cities; by 2050 the United Nations predicts that, globally, there will be twice as many people living in urban areas compared to rural. In the UK, 90% of the population is expected to city based by 2050; London alone is expected to reach 10 million over the next decade.

UK rural and urban population at Mid-Year, 1950-2050



Source: United Nations, Department of Economic and Social Affairs, Population Division (2018)

Temporarily interrupting the long-term growth trend, the outbreak of Covid-19 has caused a lull in demand for office space. This is a natural result of the economic impact national and regional lockdowns have had on the country. Demand for offices is tied to economic growth and levels of employment and as a result it fluctuates over time. There is strong demand when an economy or city is prospering, employment rates are rising, and employers seek to expand office space to accommodate growing numbers of workers. Likewise, when economies stall, as we have seen so far this year, demand for office space falls.

However, far from signalling the end of the office and the beginning of a new era of remote and home working – as many commentators have been quick to predict – it is more likely to mean a marked change in how offices are used and the overall quality of the space.

There are several reasons for this more optimistic outlook, the first of which can simply be attributed to basic human nature. Humans are social creatures at heart, and long-term isolation from colleagues is, by and large, not conducive to creative and vibrant team thinking. While it may be relatively easy to maintain relationships over Zoom or conference calls, building new business relationships is no doubt far easier when meetings are conducted in person. While flexible home working may well become a popular option in future for many to break the monotony of nine-to-five commuting, it is implausible to predict that everyone will work remotely forever.

There is also a need at a corporate level to establish a headquarters in which a company 'hub' can be created, where new employees are inducted and where teams can work together. A key change will be that these 'hubs' will increasingly need to be more modern, more efficient, and offer more attractive incentives to employees.

Up until 2020, the ongoing trend within office real estate was one of 'densification', the cramming of more and more workers into a space. The impact of a pandemic will most certainly mark the end of this practice. The safe enforcement of social distancing requires 135 sq.ft of space per person and according to analysis by Knight Frank, current densities in the City and Docklands areas of London are 126 sq.ft and 104 sq.ft respectively, far below what is necessary. At a basic level, the need to offer employees more personal space could lead to an increase in demand for bigger offices.

Future demand for office space is also likely to be guided by the facilities and amenities on offer. Companies are increasingly focusing on the benefits they can provide to employees, particularly given 'pandemic' strategies will form part of corporate planning for many years after the experience of 2020. Derwent London, an office REIT, has recently outlined its plans for a 'touch free' office development in London, where contactless journeys through the building are the focus along with more spacious stairwells, increased natural ventilation, and secure lockers and bike storage. Similarly, Helical, a design-led REIT creating buildings for today's occupiers demanding more inspiring spaces have, over the last 5 years, incorporated market-leading amenities into their buildings, in which 100% of the common areas in their London portfolio are either new or refurbished. Add into this the growing requirement for employers to consider the mental wellbeing of their staff, the expectation is that offices will need to offer much more than just four walls and desk space in the years ahead.

Source: Derwent London plc Interim Results 2020

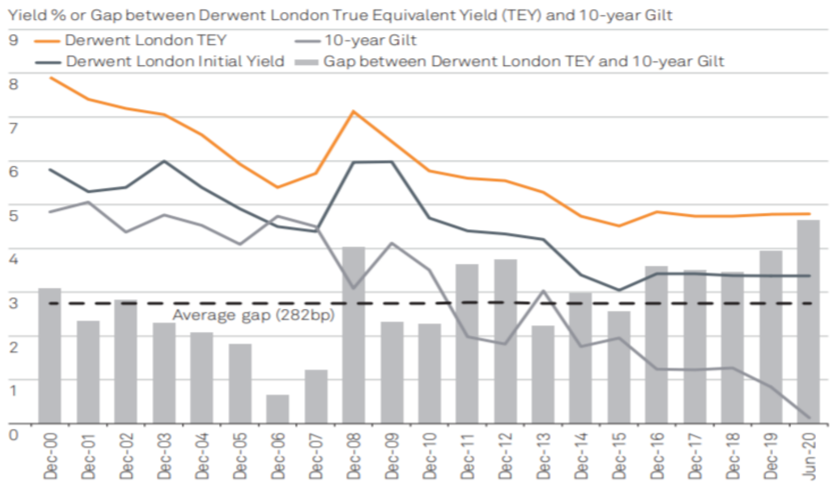
For an investor, it is REITs that offer a prime entry point to gain exposure to this new generation of office buildings. In the City of London, recent iconic developments of modern office spaces such as the 'Cheesegrater' and 'Walkie Talkie' were developed by diversified REITs, British Land and Landsec, respectively. Once leased, both REITs decided to monetise their investments and sell the buildings for a healthy profit, capitalising on the strong demand from income-hungry investors for modern offices to let to good tenants. Specialist REITs like Derwent London, Great Portland, and Helical offer some of the purest exposures to design-led, environmentally friendly, well-located, Grade 'A' offices.

A key aspect of these new developments is the environmental sustainability of the space. With net-zero targets on the horizon, new offices can no longer be the energy-guzzling behemoths of times gone by and are increasingly environmentally friendly. The REITs mentioned above understand that for a corporate entity that prides itself on its own ESG credentials, the office space it leases must match its public commitments. Tech giants such as Amazon and Google are among the big businesses focused on ensuring their eco-friendly credentials are reflected in the office space they use, with renewable energy and reducing carbon emissions a top priority. To attract good quality tenants and ensure the longevity of the asset itself, REITs now focus on reducing carbon emissions from the initial construction through to the day-to-day functioning of the building. The increasing focus on the environmental performance of offices is leading to the emergence of a green premium for such assets.

Large cities such as Edinburgh, Manchester, the centre of the 'Northern Powerhouse', and London are the prime beneficiaries of the evolution in office real estate, with offices in the peripheries looking likely to struggle to compete on many fronts. Rather than hold on to or grow smaller secondary offices – which are often older, less economically viable and environmentally unfriendly – companies may well close them and have employees in smaller areas work digitally from home. Commentators have labelled this the 'hub and virtual spoke' approach, with companies running a central office in one of the UK's big cities, with all other office activity conducted virtually and generally from home.

Increasing demand in cities versus declining demand in the periphery means that investors should consider the office exposure of their holdings, and stock picking is of vital importance. Identifying the best owners, developers and operators of offices means that it is possible for investors to gain exposure to strong yielding assets even in a sector as cyclical in nature as office real estate. REITs such as Derwent London and Great Portland with a focus on London offices, and Helical with exposure to Manchester too, look to develop and own assets that can be leased to a diverse tenant base, providing secure income, and potentially, rental growth when the economy recovers.

Example: the yield spread, Derwent London vs 10-year Gilts



Source: Derwent London plc

The yield spread between offices and Government bonds is at its widest level in more than a decade. The increasing prospect of an effective vaccine, and the likelihood that workers will start to return to offices rented by good quality tenants that continue to pay rents in full, marks specialist office REITs out as a significant opportunity, particularly for income investors.

We do not believe we are looking at the end of the office, what we are instead witnessing is the end of the traditional office as we know it. **The VT Gravis UK Listed Property (PAIF) Fund** is exposed to office REITs which specialise in the sub-sector and are at the forefront of developing the next generation of office buildings. The draw of the big city will remain, and identifying how the market is adapting is critical to successful investing in this sector.

Matthew Norris, CFA
Director of Real Estate Securities
Fund Adviser, VT Gravis UK Listed Property (PAIF) Fund
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