CROMWELL PROPERTY GROUP

OFFICES 2025 - THE NEXT EVOLUTIONARY CYCLE

RESEARCH BRIEFING NOTE

October 2021

INTRODUCTION

The enforced mass homeworking caused by the pandemic has viscerally demonstrated that in today's tech-infused world knowledge-based 'work' is an action, not a place, and it need not necessarily be performed in an office. This has triggered much public debate on the purpose of offices and what future they might have.

This briefing note sets out our views on this important topic. It begins by examining recent events and their impact on offices. It considers what this means for the future role of offices and the resultant implications for occupier demand. It concludes by setting out strategy recommendations for investors seeking to maximise upside and minimise downside in the context of structural change.

WHAT HAS HAPPENED?

Government mandates to contain the spread of COVID-19 obligated European workers who could work from home (WFH) to do so. Millions of formerly office-based employees instantly gave up their daily commutes and workplaces. Rather than leading to collapsing output, organisations realised how many tasks could effectively be performed at home with either neutral or positive productivity impacts.

Employees valued the travel time and cost savings that WFH provided and its greater flexibility. Employers eyed-up the cost savings that office-less work could provide. As uncertainty over the ability to re-occupy offices endured, some employers took the opportunity to end existing leases or delay signing new ones.

THE TAKE-AWAYS

Office demand is evolving, not disappearing. Offices will remain an indispensable business tool if they are of a form and function which enables future working practices.

Rapid workspace recalibration means polarising occupier demand onto future-proofed winning offices at the expense of the rest, driving major value creation and destruction.

Investors that act with conviction to dispose of misaligned stock and acquire product which is, or can be, aligned to future occupier demand will capture out-performance.

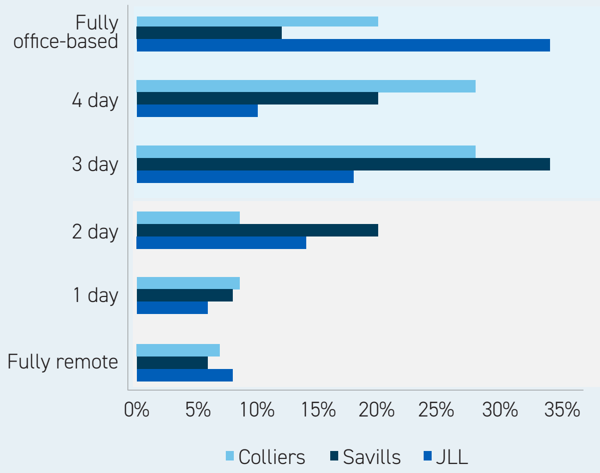
As a result, recent European office take-up and investment volume data has been poor. Leasing activity in 2020 was 37% lower than the previous year[1] and office investment volumes were down by 21%[2]. Average prime vacancy rates in seven main markets[3] have risen 275 bps since Q1 2020[4]. Simply maintaining rents has been hard for many landlords which explains why European prime offices returned 15.0% in 2019 and 3.5% in 2020[5]. This evidence, coupled with uncertainty over the need for, and viability of offices in the post-pandemic world, has understandably led to a high level of investor caution with regards to the European office sector.

WHAT WILL HAPPEN POST-PANDEMIC?

Office leasing and transactional evidence is retrospective data. Given the magnitude of events over the last 18 months the data was always bound to be poor. Conditions were atypical though and do not represent the post-pandemic environment. Forward looking data provide a better indication of the shape of future demand. This presents a far more nuanced picture from which the following conclusions can be drawn:

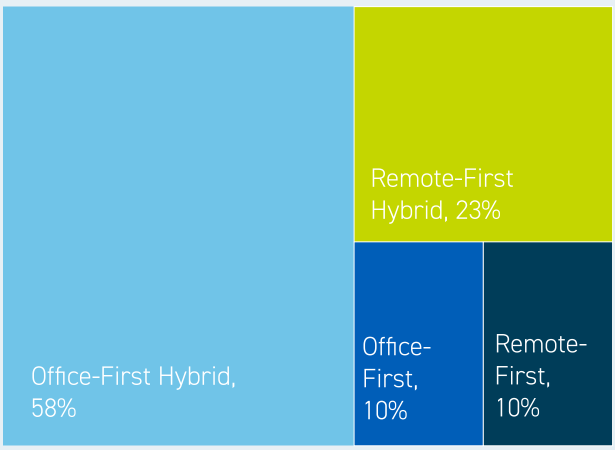
1. **Offices are desired.** Survey data repeatedly shows that both employees (Figure 1) and employers (Figure 2) value the office and want to return there. WFH does not work for many employees, for example those that live in small apartments, have young families or need creative team collaboration. Maintaining existing networks is relatively straight-forward remotely but cultivating new ones is harder. On-boarding and teaching staff remotely is challenging. Many employers deem the office essential for fostering growth, sharing company culture, branding and client engagement. Offices remain an indispensable business tool;
2. **Workplace patterns will change.** Most employees and employers favour a split home/office working week. Commonly labelled the 'hybrid' model, it can more accurately described as the 'office+' model given that a plurality of staff and businesses expect to spend the majority of the working week in the office. Whilst this may allow some employers to downsize their office space, most will still need the capacity to accommodate the full team at short-notice. This will either require occupiers to maintain large floorspaces directly or defer demand to flexible leasing solutions. Either way aggregate demand in sought-after office locations would largely be maintained;

Figure 1 - Employee surveys: Weekly post-Covid workspace preferences



Source: Savills (2020) / Colliers (2020) / JLL (2021)

Figure 2 - Occupier survey: Post-Covid workforce plans



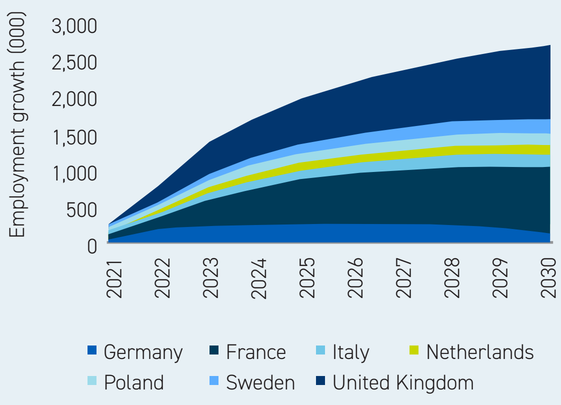
Source: Cushmans / CoreNet Global (April 2021)

1 CBRE ERIX, Q4 2021
2 RCA, Q4 2021
3 Comprising Amsterdam, Berlin, London, Milan, Paris, Stockholm, Warsaw
4 CBRE ERIX, Q4 2021

Figure 3 - Home-based efficiency: Time spent WFH without productivity loss

Source: McKinsey & Company (2020)

Figure 4 - European white collar jobs: Rolling annual total growth 2021-31



Source: Oxford Economics (September 2021)

3. **Task-based locational choice.** The pandemic has shown that some tasks are better suited to the office and some to the home environment (Figure 3). To maximise productivity office space will pivot towards facilitating the specific tasks for which it is best suited, primarily those based on collaboration, teaching, selling, interpersonal communication and creativity. That means more space for meeting rooms, break-out areas, social interaction and knowledge-sharing and less for desks. It also means adaptable space which can be adjusted to cope with fluctuating numbers of employees undertaking different activities on any given day. This suggests the propensity to use the office will vary by industry and role depending on the tasks of individual businesses and employees;
4. **Employment will grow.** European 'white-collar' jobs are set to rise by 2.7 million over the next decade[6]. Even if office space demand per employee is rebased at a lower level, the magnitude of growth implies occupier demand for offices will still grow. Because the workplace remains an essential tool in attracting and retaining talent, particularly younger gen-Z workers who indicate the strongest desire to be office-based[7], growth will be focused on the best quality space capable of matching employee requirements;
5. **Incentives to shape behaviour.** As the pandemic lingers employers will refrain from enforcing a return to offices in the short-term. Given the importance with which they view offices in facilitating long-term strategic growth[8], once the pandemic is mitigated stronger incentives, such as plush offices and additional on-site perks, and penalties like pay adjustments will be wielded to influence behaviour. Employers will experiment with multiple approaches, many of which will fail, but what works will gradually emerge and be widely copied. Employee preferences may also shift when office networking, educational and asymmetrical information transfer benefits are clearer. This is likely to tilt employees towards office-working over the medium and long-term.

All this suggests that office demand is evolving, not disappearing. The type of offices that businesses need in the post-pandemic world will change to reflect new working practices. This has significant investment ramifications.

5 Ibid, unweighted average total returns in the main European office markets
6 Oxford Economics, Q4 2021. Note: Office aggregate comprises: Information & communication; Financial & insurance activities; Real estate activities; Professional, scientific & technical activities; Administrative & support activities
7 Hubble survey of 1,000 workers, August 2021
8 (Y)our Space, Knight Frank, February 2021. Based on a global survey of 373 corporate occupiers

WHAT DOES THIS MEAN FOR OFFICE PERFORMANCE?

The Office+ model that will emerge post-pandemic represents the completion of shift in the purpose of the office from an input model – accommodating a stable and defined number of employees daily – to an output model in which its office value is judged on its productivity benefits. This shift predates the pandemic but has been accelerated by it, bringing forward change that would have happened slowly over five to ten years into perhaps two to three.

Once the pandemic is mitigated, occupiers will have the confidence to enact future workplace strategies. Occupier demand will recalibrate quickly with activity polarising to amenitised, adaptable, collaboration-focused winning offices at the expense of the rest. A greater range of additional uses such as café, restaurant and leisure space will also be needed in the office itself or within the immediate locality to both incentivise employees and to reflect the modern nature of work.

The shortfall of such stock is already significant. In Q3 2021 prime vacancy in the largest European office markets[9] was an average of 4.0 percentage points lower than average vacancy[10]. This will be exacerbated as more occupiers seek prime stock and the development pipeline cools until market confidence returns. Prime vacancy is projected to decline further by an average of 1.7 percentage points by 2024[11]. Landlords that already own or can create the stock occupiers need to maximise talent choice, attraction, retention and productivity in the post-pandemic world will capture competitive occupier interest. This will be reflected in higher rents and fewer voids.

A large proportion of European office stock is misaligned to future occupational demand, especially when increasingly stringent sustainability requirements are overlaid. The best-case scenario for such stock is that it will need significant capex; the worst-case is that offices which lack the ability to be upgraded, which are located in the wrong macro or micro location or where operational efficiencies cannot be viably improved will become unlettable and illiquid. Significant capital destruction will eventuate.

After the pandemic occupiers will be more discerning when leasing space given they have greater optionality in meeting their workspace needs. A productivity focus means resilient offices must demonstrate their value through data. The most desirable buildings will be smart and ingrained with technology to maximise space optimisation, talent satisfaction and sustainability. They will be adaptable and capable of iterating their offer in real time.

Occupiers will be increasingly unprepared to commit to long-leases and will pay for flexibility. Office lease terms fell during the pandemic[12] and this trend will outlast it. This will increase perceived leasing risk but for winning assets, lease events will be an opportunity to capture additional value through rental uplifts.

More intensive asset management and a more customer-orientated approach will be needed to enhance the experience of office workers. It will offer a point-of-difference which will attract occupiers and underpin income maintenance and growth. Offices will also need to allow for the greater provision of on-demand flexible 'space-as-a-service' floorspace. It is estimated that up to 30% of corporate space may be flexibly leased by 2030[13]. This will force landlords to pivot towards a more operational management style.

9 Comprising: Amsterdam; Berlin; Frankfurt; Helsinki; London; Milan; Munich; Oslo; Paris; Prague; Rome; Stockholm; Warsaw
10 CBRE ERIX, Q3 2021
11 ibid
12 Office leases are getting shorter, JLL, 13 July 2020
13 The impact of COVID-19 on flexible space, JLL, July 2020

WHAT DOES THIS MEAN FOR INVESTMENT STRATEGY?

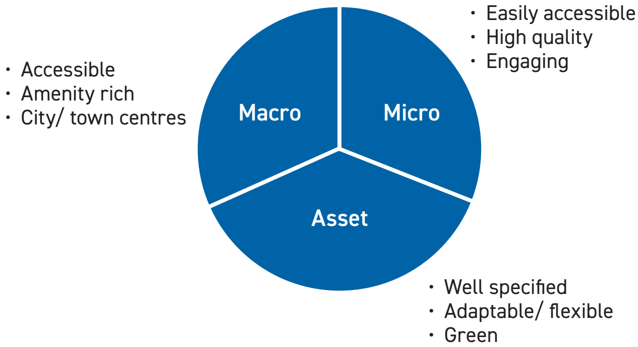
Whilst the latest office evolution will be viewed as a risk to many, to savvy investors it presents an unparalleled opportunity. A lack of stock, occupier unwillingness to compromise and the presence of clear physical requirements which can be used to screen office investment, divestment and management opportunities means a targeted strategy can uncover significant value. It can capitalise on market uncertainty and price discovery to acquire mispriced or under-valued stock with winning fundamentals. As occupier demand migrates to these winning offices, their owners can expect:

- Regular rental uplifts through shorter leases;
- Space optimisation and efficiency maximisation through integrated sensors;
- Income optionality and diversification through incorporating mixed use;
- Competitive leasing interest and near limitless potential to attract new occupiers;
- The ability to create new income through soft overlays such as in-building apps or events;
- Rising capital values.

Harnessing this potential requires a strategy that allows investors to act with conviction. A successful strategy must target winning assets in winning micro-locations in winning markets to the exclusion of all else. All three dimensions are essential to favourably harness structural change and mitigate the downside risk.

Winning macro locations comprise accessible, amenity rich city and town centres supporting a critical mass of occupiers and non-office uses. Employees who are in the office less frequently will seek to maximise the days that they are in. This means a greater willingness to endure longer commutes to a larger market where their holistic needs can be met rather than a closer but smaller market. This implies that city centres will remain the preferred office location.

Figure 5 - Uncovering value: The three fundamentals of future office performance



Source: Cromwell Property Group (2021)

Winning micro locations will have easy access to public transport nodes, walking and cycling routes. They will provide a strong sense of place with a diversify of uses in which people will want to spend time.

Winning assets will be those with the physical capability to be aligned to changing occupier demand. This mandates aspects like minimum floor-to-ceiling heights, core positioning, vertical lift/ stair access, energy efficiency, mechanical and engineering capability, lobby size and so on. They have a physical form that is able to accommodate the integrated technology and sustainability requirements of modern occupiers coupled with the flexible, task-based and experiential environment needed to capture value.

In conclusion, short-term structural change in office markets will allow investors who understand the future role of offices to construct portfolios aligned to future demand and an unparalleled opportunity to position for sustained medium- and long-term performance. To benefit investors must act with confidence, engage with informed partners and act quickly.