Pressure on office property market growing for many years, Covid-19 just boosted it

By John Loos

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It is fashionable to have an opinion on how the Covid-19 crisis is "changing the world". And forced lockdowns translating into remote working from home has put the spotlight on how the virus is changing the way we work.

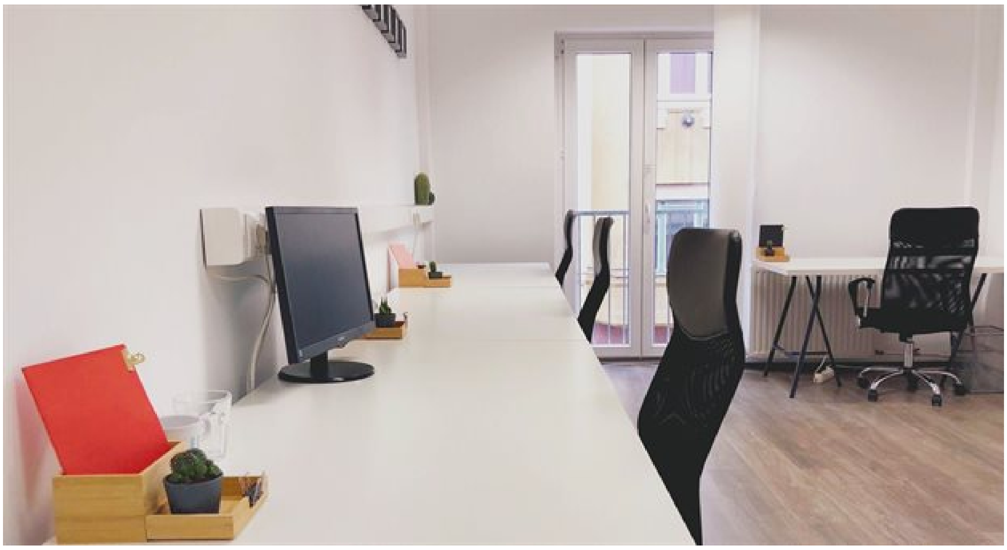

Image source: www.pexels.com

The truth is that the trend towards increased remote working has been in place for many years, and the Covid-19 crisis is merely speeding up the process. In the process, office property has been under pressure for some time, and this could mean more to come, as many companies see an opportunity to reduce costs on office premises in what is becoming a time of severe financial pressure.

Pressure on office property market

The office property market has been under the spotlight during the Covid-19 crisis, as forced lockdowns and remote working for many office workers has led many to question its future.

But the sources of pressure on the office property market have been increasing over decades. There was a time when office property was more prized as an investment, possibly “up there” with prime retail property, if the long-term history of capitalisation (Cap) rates is anything to go by.

Rode’s National Cap Rates show the National Average De-centralised Multi-Tenanted A-Grade Office Cap Rate (10.3%) to have been lower than the National Average Regional Retail Shopping Centres Cap Rate (10.5%) as at the beginning of 1990.

Shortly thereafter, however, the positions reversed, and these days it’s a different story. At the beginning of 2020 the National De-centralised Multi-Tenanted Office Cap Rate at 10.1% was 1.8 percentage points higher than that of regional shopping centres, as well as being higher than the Prime Industrial Cap Rate 0f 9.6% (the latter also having been higher than that of office space at the start of 1990).

MSCI data shows office property to have been the underperformer of the major three commercial property sectors since the start of its data in 1995, having averaged total returns of 12.3% per annum, compared to the 15.1% of industrial and 15.6% of retail.

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Decay of SA’s CBDs

From perhaps the 1980s and into the 1990s, the decay of many of South Africa’s CBDs (central business districts), and the growth of major de-centralised office nodes probably contributed to too much overall office space as some companies exchanged the CBDs for the de-centralised nodes.

Key economic drivers “underperformed”

But the office property market was also experiencing the impact of technological advancement in various ways by the 1990s. They could in many instances cut down on paperwork and the need for storage space of documents in the office environment, while services sectors that were key drivers of office space demand were achieving in part technology-driven productivity improvements.

The financial, real estate and business services (FREBS) sector is a major driver of office space demand. And its cumulative real GVA (Gross Value Added) growth of 191.9% from early-1993 to end 2019 has well-outstripped the “retail and wholesale trade, catering and accommodation” sector’s 119.7% (key driver of retail space demand) and the manufacturing sector’s 66.3% (a key influence on industrial property demand).

But, in the FREBS sector’s case, it is not production volume or value that is the key influence on office space demand, but rather the employment levels and trends in this sector. And ongoing productivity improvements saw to it that employment growth in the FREBS sector was far less impressive than its GVA growth, recording cumulative growth of only 52.6% over the period using a long SARB employment index history for this sector. This was lower than both the retail and wholesale trade, catering and accommodation sector GVA growth, as well as that of manufacturing.

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“Underperforming” office-related economic fundamentals

The “underperforming” (in a space demand growth sense) key economic driver of office space demand therefore seems to in part explain office property's underperformance of the other two major commercial property sectors in recent decades.

Actually the FREBS sector has been an "outperformer" in the GVA growth sense as well as in the sense of productivity improvements. But this outperformance is "underperformance" in the sense of driving growth in demand for office space.

Comparing long term trends in indices for real values/square metre, (inflation adjusted using GDP inflation), it would appear that the relative performance of the key property sectors' economic drivers may largely explain the relative performance of the real property values/square metre over a similar period from 1995 to 2019. The outperformer was retail, whose real value/square metre was 99% higher in 2019 than in 1995, followed by industrial property whose real value was 55.2% higher. The office sector, by comparison, was only 32.2% higher.

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Long-term residential densification trends

The pressure goes further, with office working life becoming increasingly unattractive in many ways, especially in many major business nodes.

Since the late-1970s and into the 1980s, economic infrastructure investment declined, including investment in urban transport infrastructure. Urban residential densification ensued as it needed to, but traffic congestion became far worse. Public transport solutions have not kept up, and commuting to many of the country's major office nodes has become increasingly costly and time inefficient.

According to properties valued by FNB over the years, average full title stand size on properties built over the past decade has about halved compared to the stand size of those built in the late-1970s.

In addition, sectional title properties built have increased significantly as a percentage of total properties built over the years.

Initially, as decaying CBDs became unpopular, shifts by business to well-run and well-maintained de-centralised nodes, that were less congested at the time, increased the appeal of commuting and office working for many, as opposed to commuting to the CBDs. But over time many decentralised nodes have suffered the same traffic congestion fate as CBDs in earlier times.

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Open plan offices

In addition, one must consider the long-run trend in modern office design towards open plan space with shared meeting facilities. This has not come without criticism. Open plan can save on space, in many instances assisting with densification in the office space, a further constraint on overall demand growth. But the sacrifice is often employee distraction through surrounding activities and noise, and resultant productivity loss, depending on the work activity. The analytical types who require concentration can be particularly hampered in an open plan office.

Covid-19 and remote working

Right now, as we are caught up in Covid-19 compulsory remote working, it is fashionable to dream up a myriad of ways in which Covid-19 will change the world forever, so the list of reasons why employers should allow staff to work from home seems to get longer by the day. Amongst some I've read are that remote working "increases productivity" (after what has been said about open plan offices and time spent commuting), "ensures business continuity in pandemics", "attracts talent through making a company more popular to work for", "boosting staff morale", and "job satisfaction".

Office working has its supporters too

I suspect it suits many staff to work from home, but not all, depending on their home facilities and security situation, as well as the potential distractions at home, which can be numerous too.

The "old school" supporters of having people work from the office would point to the "team spirit" that staff being together for a significant amount of time can foster. For sure, being in the same physical location together can get people to know each other better. But this can swing either way, either building a strong team where personalities suit each other, or causing teams to fall apart where they don't.

The supporters of office working would also point to those casual "coffee machine conversations" from which great ideas and innovations often flow. And I understand that. There is some truth in this argument too.

There are many arguments for and against remote working ….but ultimately company money will likely talk. There are thus many arguments for and against remote working. But at the end of the day, I expect the Covid-19 crisis to lead to further dampening in the demand for office space, as greater support for remote working comes about from company managements.

However, I believe that the reasoning will be far simpler than many of the elaborate arguments that are made for remote working. It will be simply about cost cutting.

The forecasts are that we will have the biggest recession in post-World War II history this year. The commercial sector financial pressure will be severe and it will be looking for ways to cut costs. The technology exists to work remotely, and we've all been forced to learn to use it. What better way to cut costs than to reduce their amount of office space. In short, a simple financial argument is the most likely driver.

We would thus expect the office property market to come under greater pressure than that of recent times as growth in demand for office space comes under further pressure.

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6 May 2020

Extent of post-Covid-19 shift to remote working

How big is the immediate post-lockdown "work from home" drive likely to be? That is tough to tell. But I came across a US survey by Gartner published on 3 April of a sample of company CFOs in the US, and their intentions with regard to letting their staff work remotely.

74% said they intended to move some of the staff to remote work permanently. But what portion of staff? They were given options, 26% replying that zero percent would work remotely, 27% saying 5% would work remotely, 25% responding 10%, 17% responding 20%, and only 4% responding 50% and 2% saying more than 50% working remotely.

This signifies a significant portion of employees relocating to home, but the majority still going back to the office in the immediate future. Such a portion starting to work remotely would, however, create a sizeable drop in demand for office space and likely a noticeable rise in average vacancy rate.

One cannot conclude that this survey response would be the same if done in South Africa. But SA also has the deep recession and the forced remote working through the lockdowns. And the technological solution appears to have worked quite well. So it is realistic to expect that more than one CEO in SA is also considering reducing office space use in a severely financially pressured environment.

Covid-19 has not started the trend. Office property has had mounting pressures for some time, and remote working has been on a gradual rising trend well in advance of 2020, as technology advances. Covid-19 merely looks likely to speed the process up considerably.

With the national office vacancy rate already at a high double-digit level, this is not a convenient time for office landlords, especially those in many of the high vacancy prime decentralised nodes of Gauteng.

ABOUT THE AUTHOR

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