IMPLICATIONS OF WORKING FROM HOME (WFH) ON THE OFFICE REAL ESTATE SECTOR

NOVEMBER 2020

QIC Investment Insights Paper

This document has been prepared by QIC Global Real Estate (QIC GRE) to capture the collective view on the implications of COVID-19 across the office sector as relevant for the QIC GRE business. Input has been provided by the QIC GRE Fund Management and Investment Management teams and the QIC Economic team.

The implications and forecasts provided reflect the view as at the date of this report, however due to the ongoing dynamic nature of the COVID-19 pandemic the impacts and conclusions noted are not necessarily definitive and will need to be revisited as the pandemic progresses and markets continue to adapt.

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1. EXECUTIVE SUMMARY

COVID-19 has significantly impacted the global economy, dragging Australia into its first recession in 29 years and leading to a reduction in economic activity across 2020 and 2021 of an estimated $200 billion. Australia's economy is relatively better positioned for recovery than countries that have not enacted large-scale stimulus of the same magnitude, or countries that have been less successful in containing the spread of the virus.

The real estate sector has felt the impact of COVID-19, producing an acceleration of the structural changes shaping the future of the sector.

Its influence on the office sector in Australia is particularly evident in the reduced demand for office space and subdued white-collar employment rates around the country as a consequence of the economic recession. With the recovery of labour markets expected to be gradual, demand for office space is projected to reduce by 700,000 sqm over 2020 and 300,000 sqm over 2021 from pre-COVID levels. QIC Global Real Estate (QIC GRE) expects to see downward pressure on rental rates, with vacancy rates expected to be 600 basis points higher than previously forecast[1].

In addition, the demand for office space will be impacted from the accelerated trend towards work from home (WFH) or more flexible working arrangements. While companies are expected to retain 'flagship' central/CBD locations, formalised flexible working arrangements are likely to become more commonplace:

- An average of 50% of the workforce is expected to WFH two days per week post-COVID-19[2].
- Activity-based working is expected to increase moving from the traditional arrangement of one desk per employee to a more flexible structure. Supported by appropriate technology, including desk booking systems, this will provide employees with the flexibility to WFH and hot-desk in the office.
- Flexible space will be introduced, including co-working, shared base building amenities (such as board/meeting rooms) and home or satellite offices.
- Density levels will reduce. An increased focus on social distancing and health and wellbeing will result in more space per employee.

Based on the above assumptions, QIC GRE calculate that WFH arrangements will result in **an estimated 5% net fall in demand**[3]. This is expected to see growth rates across Australian CBDs fall well below current market consensus forecasts, placing downward pressure on asset values.

The impact on demand for office space will depend on the relative quality of the asset, its ability to accommodate evolving occupier requirements and preferences and the certainty of cashflow. The most productive assets will address most, if not all, of the following key attributes:

- Precinct and surrounding amenity
- Location and proximity to transport infrastructure
- Design and quality
- Health and wellbeing
- Technology and connectivity
- Flexible accommodation services.

[1] QIC, Oct 20.
[2] QIC, Oct 20.
[3] QIC, Oct 20.

2. THE IMPACT ON EMPLOYMENT AND THE OFFICE SECTOR[4]

The sharp contraction across the Australian economy subdued white-collar employment nationally, resulting in a weakening of office space demand. While the accommodation, food services and arts & recreation industries experienced the greatest impact, industries more closely linked to office demand have also seen significant job losses:

- Jobs in IT, media and telecommunications have fallen by over 9% from mid-March to early October
- Jobs in administration & support and in professional services have fallen by around 5% over the same period.

The labour market is expected to recover gradually:

- The unemployment rate is expected to be ~7% at the end of 2020 and ~6% by the end of 2021.
- Total employment in Australia is expected to fall by ~3% by the end of 2020.
- Employment in Australia is not expected to reach pre-COVID levels until the end of 2021.

The economic recession is projected to reduce demand for office space across the CBD office markets by 700,000 sqm over 2020 and 300,000 sqm over 2021 compared to projections made prior to the COVID-19 pandemic, with the consequential increase in vacancy rates to be 600 basis points higher than previously forecast, placing downward pressure on rental rates.

3. IMPLICATIONS OF WFH ON THE OFFICE SECTOR

While the Australian office real estate sector has enjoyed strong occupier and investor demand during the past cycle, the COVID-19 pandemic, in addition to impacting economic drivers relevant for the sector, has impacted the way that occupiers will utilise office space moving forward. There will be a greater propensity for employees to work more regularly from home.

As businesses encourage employees to return to offices it will become more evident to what extent there is surplus space in existing tenancies. This will lead tenants to reduce their leased space on expiries and renewals or drag on the growth of office demand going forward as that surplus capacity is absorbed.

The intentions of occupiers have so far been captured by surveys that show there will be an increased amount of time spent by employees working from home. However, it should be noted that surveys may not reflect fully what corporations may implement going forward, as the surveys have typically sampled the sentiments of employees. Moreover, as the situation is rapidly evolving, employee preferences will likely continue to evolve.

A review of 12 national and global surveys provides a collective view as follows[5]:

- Approximately 60% - 75% of office workers would prefer to increase flexibility in the workplace.
- The majority of employees are seeking to work flexibly 1-3 days per week.
- The preference for WFH is highly attributable to reduced commute times (there is strong correlation between an employee’s commute time and WFH preference), savings in personal expenses and an improved work-life balance.
- Many employees believe their productivity has remained the same or increased during WFH.

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[4] QIC, Oct 20; ABS, Oct 20 & JLL REIT Report, Jun 20.

[5] Hassel, The New Workplace (Sept 20); JLL, The Future of Office Demand (Jun 20); CBRE, The Future of Global Office Demand (Jun 20); Cushman Wakefield, Global Office Impact Study & Recovery Timing (Sep 20); McKinsey, Reimagining the Office and Work Life after COVID-19 (Jun 20); ABC News, COVID-19 Won’t Kill the Office (Sep 20); CBRE, Workforce Sentiment Survey (Aug 20); QIC, Return to Office Work Survey Data (May/Jul 20); Tactic Property, Research Report (Aug 20); Owl Labs (in collaboration with GWA), State of Remote Work 2020 (July 20); World Economic Forum, Five Remote Working Myths Under the Microscope (Oct 20).

Additionally, QIC's return to office work surveys conducted across QIC Australian employees in May and July 2020 provided the following results, showing a consistent theme with the other surveys conducted.

MAY SURVEY (N=658)

'I would like to defer from the office a while longer'	**28%** of Brisbane Employees **33%** of Sydney Employees **28%** of Melbourne Employees

JULY SURVEY (N=524)

'I would be comfortable working in the office more than 50% of my usual working pattern'	**16%** of Brisbane Employees **16%** of Sydney Employees
'I anticipate I will make a Flexible Working Request to formalise an ongoing remote working arrangement'	**74%** of Brisbane Employees **72%** of Sydney Employees

However, where safe to do so, many organisations, including the Australian Federal Government, are encouraging their workforce to return to the office. As social distancing and tenancy occupancy caps are relaxed, we expect this trend to continue as organisations attempt to return to 'normal' and play their role in boosting the economic recovery.

QIC GRE has consulted with more than a dozen of Australia's largest corporate office occupiers during the month of October 2020 to better understand their intentions with respect to corporate accommodation moving forward. Although it is not yet conclusive as to what permanent changes will be put in place by these occupiers, the following themes have emerged:

- Prior to the COVID-19 pandemic there was a move towards greater flexibility in working arrangements, with most corporations having flexible working policies in place.
- Corporations will retain 'flagship' central/CBD locations with quality fit outs and technology to support culture, collaboration and innovation.
- Corporations accept a greater propensity for employees to work from home.
- An increased consideration to incorporate 'hub and spoke', co-working or other flexible working models into their accommodation planning.
- Corporate occupiers are undertaking assessments on their existing office footprints and to what extent they can be reduced, with a number already placing space on the sub-lease market.

It is clear that there will be a structural change reducing the demand for office accommodation, particularly in CBDs, over the short to medium term. There are, however, broader considerations that both employers and employees will need to consider when determining the stabilised amount of office accommodation they require over the longer term.

Implications for the Occupier

Remote working is anticipated to pose several challenges for organisations, such as talent attraction & retention, difficulties onboarding new employees, management and training, isolation and mental health issues as well as productivity.

Central to the WFH debate, many employees believe their productivity has remained the same or increased while WFH. However, this data can be highly subjective, particularly when layoffs are being made. Managerial respondents viewed team productivity to be lower compared to employee responses.[6] ABS data reiterates this point, showing that office workforce productivity declined by 3% in the 3 months to June 2020. While a decrease is common during economic downturns, the data still counteracts the increased productivity argument.[7]

[6] CBRE, 'Workforce Sentiment Survey', Aug 20.

[7] Daily Telegraph, 'WFH a drag on output, says study', Oct 20.

Consequently, the adoption of a more formalised hybrid model (both home and office working) seems viable for most organisations moving forward, with corporate offices remaining an important place for collaboration and innovation to thrive, and where a business' culture can be created and entrenched.

The environment provided in the office and the corresponding fitout of office accommodation will also need to adapt:

- Office landlords will need to address the increased need for cleanliness and wellbeing.
- The allocation of space and fitout design will likely see an increase in collaboration space and decrease in focused working areas.
- Investment in technology to facilitate connection across multiple locations and employees at home will also be required.
- Investment in the environment to provide an inspirational atmosphere for employees.

Implications for the Landlord

As working behaviours evolve, tenants are likely to be seeking greater flexibility in how they use their office accommodation, and what they use it for. The demand for office accommodation will shift in terms of both the growth in demand and its characteristics. For example, a higher uptake in remote working arrangements will weigh on demand for office space and evolve with technology and activity-based working arrangements.

Real estate solutions will change in alignment with tenant needs:

- Flexible workspaces
- Distribution of desks and workspace densities
- Infrastructure that accommodates the digitisation of businesses
- Areas for team collaboration.

Occupier surveys support a continuation of the flight to quality trend, with tenants expecting their share of higher quality office space to remain the same or increase, therefore decreasing their amount of lower quality spaces.[8] Landlords of lower quality stock will be more subject to the impacts of remote working than owners of higher quality assets.

Though WFH is expected to drag on future office demand, it is important to note that an increase in flexibility does not result in an equivalent decrease in demand for office space. Future demand is a complex combination of several factors, including;[9]

- Employment Levels
- Public Health Situation
- Technology
- Workplace Densities
- Business Confidence
- Economic Growth
- Company Culture and Innovation Needs
- Productivity Metrics
- Commuting Behaviour

[8] JLL, 'Optimism in the Face of Crisis', Sept 20.
[9] JLL, 'The Future of Global Office Demand', Jun 20.

There are various models that will be implemented by employers that are likely to range from a straightforward working from home policy through to hub and spoke or network models incorporating decentralised flexible office accommodation. Consequently, landlords may need to consider assisting tenants through provision of decentralised and/or flexible accommodation options.

Prior to the COVID-19 pandemic, co-working facilities managed directly by landlords or by third party providers (for example WeWork) provided flexibility for occupants to more easily adjust their accommodation footprint as required and offer enhanced collaboration environments. The initial impact to co-working from COVID-19 has been negative as people worked from home and avoided communal environments, but this is expected to be temporary. It is likely that the importance of co-working will increase in line with structural changes in the office sector as occupants seek greater flexibility and suburban locations.

This is in line with a general theme of 'localisation' that has become prevalent during the COVID-19 lockdowns. Additional demand for decentralised office locations will support the emergence of town centre development opportunities around existing retail economic nodes.

4. WFH IMPACT ON OFFICE DEMAND

We have considered the following when assessing the impact WFH will have on office demand:

- **Pre-COVID-19 WFH (baseline)** – According to the Australian Bureau of Statistics August 2019 data, 32.1% of employed people regularly worked from home[10].
- **Post-COVID-19 WFH** – We estimate that across all Australian CBD white-collar employment sectors, on average 50% of the workforce will WFH two days per week post-COVID-19. Our 50% view is lower than indicated in employee surveys to allow for the fact that not all organisations or staff can work efficiently from home and not all employers will allow this flexibility.[11]
- **Increase in activity-based working (ABW)** – moving from a traditional "one desk per employee set up" to a more flexible structure: allowing for a combination of WFH days with shared hot-desking in the office which is supported by technology such as booking systems. The ratio of individual desks to collaboration and social settings is expected to flip from 55%/45% to 35%/65% [12]of net lettable area. We note that the ABW model will not suit all organisations and some will be reluctant to change while hygiene and safety remain a concern.
- **The introduction of flexible elastic space** – includes co-working, shared base building amenities (such as board/meeting rooms), home or satellite offices. Organisations will take less fixed space and will use other forms of accommodation to flex up and down, reduce costs and better utilise space.
- **Workplace densities** – the trend of accommodating more people into a smaller footprint may now need to reverse, given the requirement for social distancing between employees and greater emphasis on health and wellbeing going forward. This would result in more space per employee.

Based on the above assumptions, QIC GRE estimate the impact will be a 5% net fall in demand as a result of WFH (15% fall due to greater flexibility which is partially offset by a 10% increase in space required from changes to workplace design and lower workplace densities). Under a downside scenario assuming that on average 60% of the workforce WFH 2.5 days per week, the net fall in demand could be in the order of 10%.

On the assumption that the structural WFH shift will result in a 5% impact to demand, growth rates across Australian CBDs are likely to fall well below current market consensus forecasts due to higher than anticipated vacancy rates.

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[10] Australian Bureau of Statistics, Aug 20.
[11] QIC, Oct 20.
[12] QIC, Oct 20.

Prime gross rent growth, 2020-29 average (% p.a.)[13]						
	Sydney CBD		Melbourne CBD		Brisbane CBD	
	Face rent	Effective rent	Face rent	Effective rent	Face rent	Effective rent
No WFH	3.4%	3.1%	3.6%	3.9%	3.0%	4.9%
5% WFH Scenario	**1.6%**	**0.3%**	**1.8%**	**1.3%**	**1.5%**	**2.4%**

Consequently, a 5% WFH Scenario will cause downward pressure on asset values. QIC GRE's house view is that the structural shift towards WFH and associated occupier risk is not appropriately priced into current office market valuations.

The impact on valuation will be a function of the underlying lease profile. Assets with a shorter lease expiry profile are more likely to be discounted due to the material short term impact to the occupier market. Assets with longer leases in place with strong covenants will see a relatively lower impact to valuation. We expect re-pricing to occur over the short term as the risk arising from the WFH structural impact becomes better understood and the market begins to quantify and price accordingly.

5. PREFERRED OFFICE ASSET ATTRIBUTES

The impact on demand for office space from both the economic slowdown and the structural changes will flow through to weakness in effective rents and capital values for the short to medium term. The extent of this impact on individual assets will depend on the relative quality of that asset, the strength of lease covenant/s (i.e. certainty of cashflow) and its ability to accommodate evolving occupier requirements and preferences.

The most productive will address most, or all, of the following key attributes:

- Precinct and surrounding amenity – a destination that provides critical mass of complementary tenancies and uses, offers appealing 'third places' for people to dwell and provides surrounding amenity including open space, retail, recreation and other services.
- Location and proximity to transport infrastructure – 'centralised' location (both CBD or suburban) and convenience from transport modes (i.e. car, bus, train, cycle and walk) remain key attractions for occupiers so as to be accessible from and to multiple locations via multiple means.
- Design and quality – align to leading environmental objectives in construction and operation, with a high level of finishing and servicing to differentiate the building, provide complementary branding for occupiers and ensure organisations can attract and retain the best talent.
- Health and wellbeing – provide a healthy indoor environment, natural light, cleanliness/hygiene and facilitate occupier environmental and social objectives.
- Technology and connectivity – include the necessary backbone required to enable evolving technology solutions for occupiers and ensure employees and organisations can seamlessly function within a connected precinct.
- Flexible accommodation solutions – offer occupiers flexibility in their footprint (i.e. co-working solutions), flexibility of fitout as requirements evolve, and offer multiple spaces for occupants to utilise within the tenancy, within the building and within the precinct.

[13] JLL & QIC forecasts, 2020.

6. LOOKING FORWARD

The pandemic has resulted in immediate impacts to the office sector with the economic slowdown, social distancing and WFH being at the forefront. Although WFH has been more successful than first anticipated, the extent of WFH over the longer term remains uncertain.

Studies to date point to a shift towards increased working flexibility post-COVID-19. The future of office will likely see companies adopt a hybrid model to maximise the benefits of flexible working, while mitigating its drawbacks. However, the impact is not expected to be homogeneous across office markets, employment sectors or asset types.

Our view is that office markets and investment metrics, specifically for the major CBDs, will stabilise across the medium term once the immediate impact to demand is settled and the supply of office space rebalances. The fundamental role and requirement for office accommodation is not diminishing and it remains a desirable long-term investment, particularly assets that possess preferred attributes.

Given the downside risk due to WFH is yet to be fully understood, a disciplined approach with appropriate timing of investment needs to be adopted, however this period of transition will likely present opportunity for long term investors.

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