Enough of homework?

MaxCap Group Research - September 2023

What is the new office landscape?

Pushing back on homework. As the world treats COVID-19 as a distant memory, there is an increasingly strident push (from employers and landlords) to bring white-collar workers back to the office, to encourage collaboration, restore productivity and revive city centres.

The struggle is real. After a taste of freedom at home, workers have been slow to swap tracksuits for work suits, resume their commutes and return to their desks. For many employers and employees, the compromise comes to about 3-4 days a week physically in the office.

A case of missing demand. Amid a cyclical slowdown due to higher interest rates and a structural shift to working from home, there has also been a material reduction in office net absorption over the past three years. Some of this missing office demand is permanent, which will ultimately be reflected in occupancy rates, rents and asset pricing.

Back to which office? As more workers return to their desks, they are being more selective in the location, quality and amenity of their workspaces. This is driving a widening gulf between the city and the fringe and between the different office grades and service offerings.

A market clearing price. Meanwhile, a long-awaited price correction is unfolding in Australian office markets. Certainly, there is more adjustment to come locally, but offshore markets are already finding that market clearing price, enough to bring investors back into play.

Selective on equity, credit still resilient. For investors, there is clearly a tale of two markets. Equity investors are being highly selective, keenly seeking the right entry price. Investment-grade credit exposures are still very resilient, even as major lenders retreat from this space and impose much more conservative lending terms.

A slow and uneven return

The **global office market** is seeing dramatic and accelerating change, for occupiers, managers and investors alike.

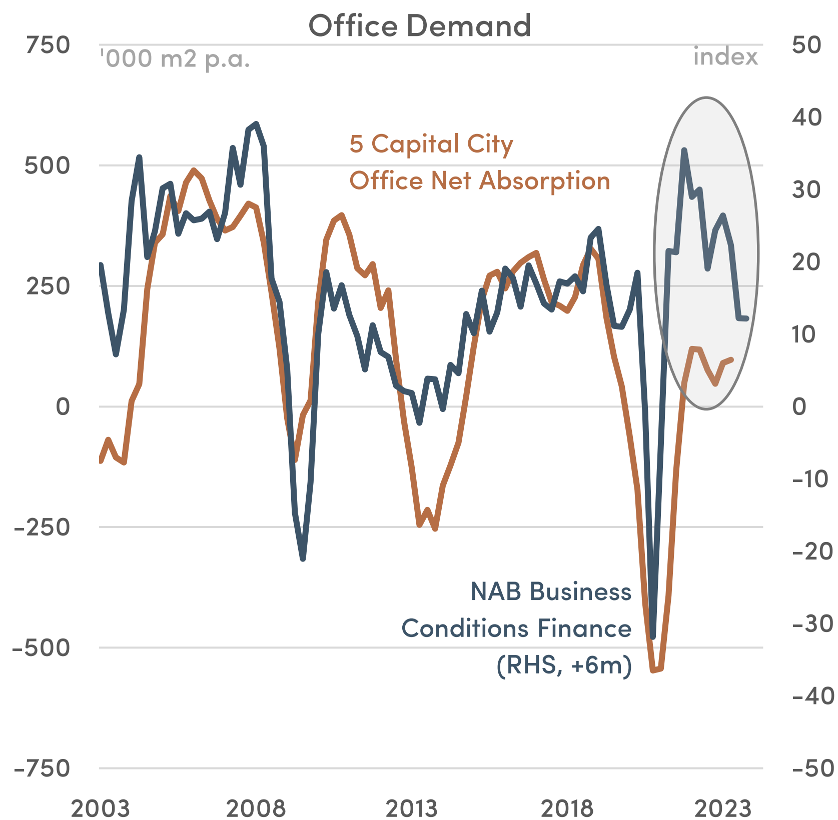
A **once-in-a-century pandemic** has prompted many workers to work from home, while rapidly-maturing **teleconferencing technologies** made remote work more sustainable. Consequently, many white-collar workers took leave from their suits, commutes and office desks and stayed at home in 2020. A few of these workers have remained there since.

As the world consigns the global pandemic to a distant memory, there is an increasingly strident push – mostly from employers and landlords – to **return workers to the office**, for several reasons. Managers are eager to reassert supervisory control. Landlords are seeking to restore office occupancy (as vacancy jumps three-fold from 2019 to 2022). Economists are looking for ways to improve sluggish productivity. On that front, the white-collar productivity numbers are subdued overall (GDP per capita 2020-22: +3%), but with sizeable differences between more-productive info-tech workers (+35%) and less-productive finance workers (-11%).

Meanwhile, white-collar workers are enjoying their taste of freedom at home, reporting improved personal productivity. Not surprisingly, **office workers have been slow to return**, especially with the rising cost of commutes in a world with elevated energy prices. For many employers and employees, the negotiated compromise differs sector by sector, but generally now sits at about 3-4 days a week physically in the office.

These structural changes have led to a clear case of **missing office demand**. Business conditions consistent with a CBD office net absorption rate of 500,000m^2 a year for have yielded less than 100,000m^2. This absence of demand (more so than the supply pipeline) has been the key factor behind the rapid run-up in vacancy rates. Additionally, there are now **weaker cyclical drivers** at play. Higher interest rates since 2022 have markedly slow business conditions and leasing markets, adding to the immense leasing challenges confronting the office sector.

The recovery in office net absorption has been absent over the past 3 years, despite a robust (but transitory) cyclical rebound in business sector conditions



Source: Bloomberg, Jones Lang LaSalle REIS, NAB Quarterly Business Survey, MaxCap Group (September 2023)

Returning to which office?

In the context of the big structural and cyclical headwinds in the Australian office market, there are some **noteworthy submarket trends** across the different categories, with deep implications for the future of the office investment landscape, particularly the allocation across asset types.

- Across four Australian capital cities, **secondary CBD office markets** have performed the worse over the past 2½ years. The contraction in demand has been more dramatic here, spurred on by the withdrawal of stock for new metro rail stations. Moreover, the corrections in effective rents and cap rates have also been the sharpest in this space.
- Similarly, **prime CBD offices** (including trophy assets) have struggled overall, with a moderate rebound in net absorption after a big dip during COVID. With the marked uplift in vacancies, there has been a material deterioration in both effective rents and cap rates.
- Meanwhile, there has been remarkable resilience in the **city fringe office markets**, quite at odds with the relative weakness in city centres. Specifically, there has been a robust demand uplift in the prime fringe segment, which held up well during the lockdown, before accelerating further upon reopening. Meanwhile, the adverse moves in vacancies, rents and cap rates have been relatively more muted.

Altogether, there has been a net reduction in **aggregate office demand** given the shift for some people to work from home on an enduring basis and the more recent cyclical slowdown due to higher interest rates.

At the same time, there are significant shifts within these office market segments – trends which are still unfolding – as **occupiers express strong preferences** for specific office segments, likely reflecting a combination of factors including better rental affordability, serviceable transport access, modern amenities and reduced crowding.

In other words, tenants and workers are still returning to the office, albeit to a different location and a different segment of the office market.

Amid a big structural demand adjustment, some market segments – especially along the city fringe – have relatively outperformed at the expense of the city centre

	City Centre [1]		City Fringe [1]	
Prime	Demand	+40k	Demand	+1039k
	Vacancy	+9%	Vacancy	+4%
	Incentives	+10ppt	Incentives	+9ppt
	Effective Rents	-13%	Effective Rents	-5%
	Cap rate	+65bps	Cap rate	+48bps
Secondary	Demand	-1,756k	Demand	+2k
	Vacancy	+5%	Vacancy	+2%
	Incentives	+11ppt	Incentives	+7ppt
	Effective Rents	-18%	Effective Rents	-9%
	Cap rate	+76bps	Cap rate	+69bps

more resilient segments

Sources: Jones Lang LaSalle REIS, MaxCap Group (September 2023).[1] Weighted average of four capital cities (Sydney, Melbourne, Brisbane and Perth) from Q1 2020 to Q2 2023. Demand is measured as the cumulative change in occupancy in square metres. Vacancy, incentives and cap rates are presented as the change in the percentage rate.

A matter of pricing

For equity investors, there is still **a lot of caution** around the office sector in Australia, given the diverse and adverse structural and cyclical factors still impacting heavily on office demand, rents and pricing.

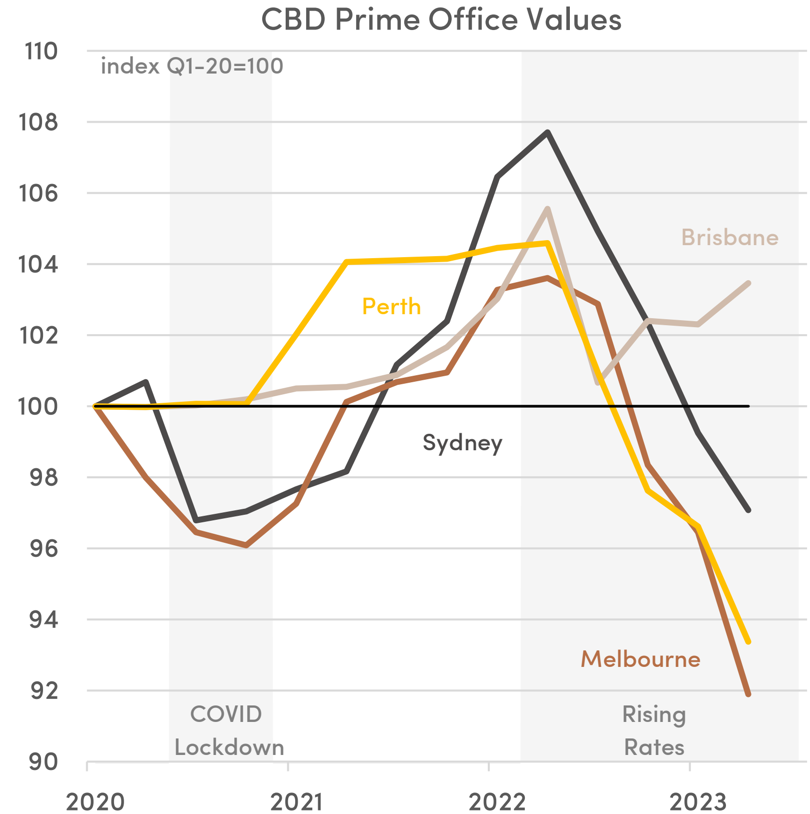
Indeed, for most potential buyers, **pricing is still the key impediment** to stronger engagement today. Value and opportunity investors are often well at ease returning early to the market, if there is a sufficient discount to account for the downbeat investor sentiment and the structural reduction in demand. The key motivator here is the potential for outsized returns.

- Meanwhile, the reset of pricing has occurred more quickly in **offshore office markets**, evidenced by the earlier and sharper falls in office asset values in Manhattan (-23%), London (-27%) and Hong Kong (-32%). Those price corrections have been sufficient in restoring some degree of fair value and reviving investor interest for the office sector.
- In **Australian office markets**, the pricing adjustment is just starting to unfold in 2023. The cumulative price falls to date have been running relatively later and in a milder manner in both Sydney (-10%) and Melbourne (-11%), slowed to some degree by a circular process of valuers holding onto yesterday's value in the absence of new transactions and a lack of buyer interest at yesterday's pricing.

While **the full extent** of this office pricing correction in Australia is still somewhat uncertain, the outlook is bookended at one end by the sharper price falls in major financial centres offshore (around -30% peak to trough) and at the other by the relatively muted price adjustments reported so far by local valuers (around -10% peak to trough).

Altogether, the Australian office market is poised for a further correction in pricing in late 2023 and likely into 2024, before the eventual trough in prices and the subsequent rebound in trading volumes. **Securing a sufficient pricing discount** would be the key for potential buyers looking to return to the market ahead of the cyclical trough.

While office asset values held up during the lockdown, the more recent impacts of higher interest rates and cautious investors are driving deeper price corrections



Source: Jones Lang LaSalle REIS, MaxCap Group (September 2023)

Two investor perspectives

In light of the well-reported challenges facing the Australian office market – elevated vacancies, shifting demand and falling values – investors are being **far more selective** in their approach for this sector.

Investors are down-weighting their portfolio allocation, lenders are dialling down their exposures and owners are becoming somewhat more hesitant about new office developments and older office refurbishments. In this context, what is a level-headed assessment of the **investment outlook**?

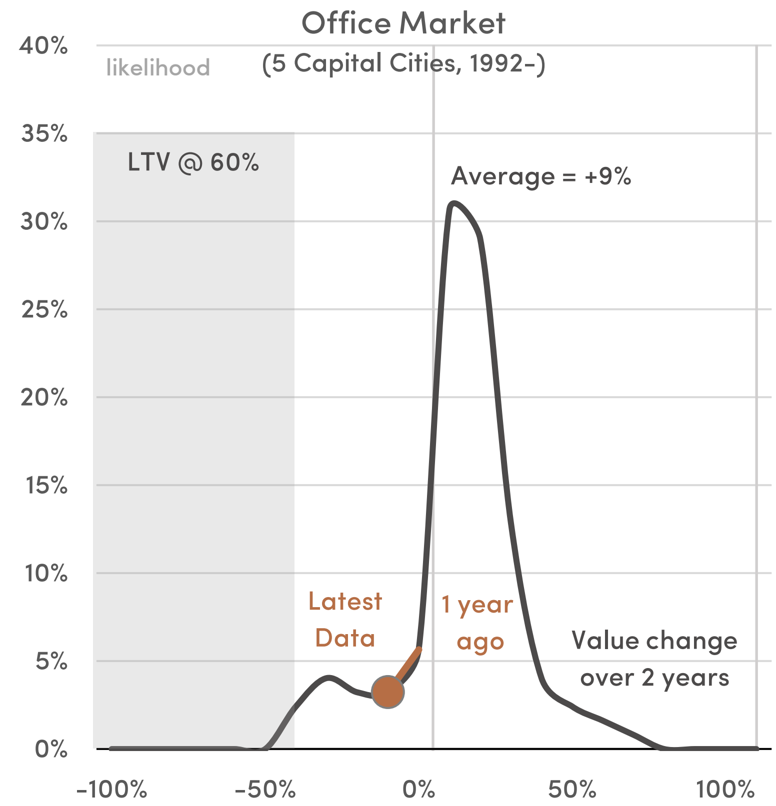
In our view, there are two distinct **investor perspectives** for the office market, one for the equity and another for the credit.

From the **equity** perspective, market fundamentals are likely to remain challenging for some time, as pricing weakens further for both cyclical reasons (high interest rates, sluggish business conditions) and structural reasons (work-from-home demand shift, portfolio re-weighting).

- For **core** investors who need to keep buildings full and collect rents, office markets are likely to underperform against other sectors over the next year. For **value-add** investors able to undertake development or refurbishment works, there is more opportunity ahead, but it requires tight management of construction costs and schedules and – some time down the track – lower interest rates.
- What is particularly interesting is the rising scope for **office-to-residential conversions** (for the right floorplate) and even **office-to-land conversions** (where there are discounts below land value).

From the **credit** perspective, the office outlook is sanguine, despite these challenges. Price falls are still not sufficient to completely erode the equity position and expose the debt, especially as lenders reduce leverage ratios even further. Rising costs and builder failures require much more active management of the loan book, but so far with limited impacts on repayment incomes and credit returns. All told, there is still remarkable resilience in office credit, amid diminishing competition from other lenders.

Falls in office values have been subdued so far, with more expected into 2024. Even so, the risks to credit are quite constrained, given conservative lending ratios



Source: Jones Lang LaSalle REIS, MaxCap Group (September 2023)

Additional information

#1
in Australia

PERE RED 50

#2
in Asia Pacific

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