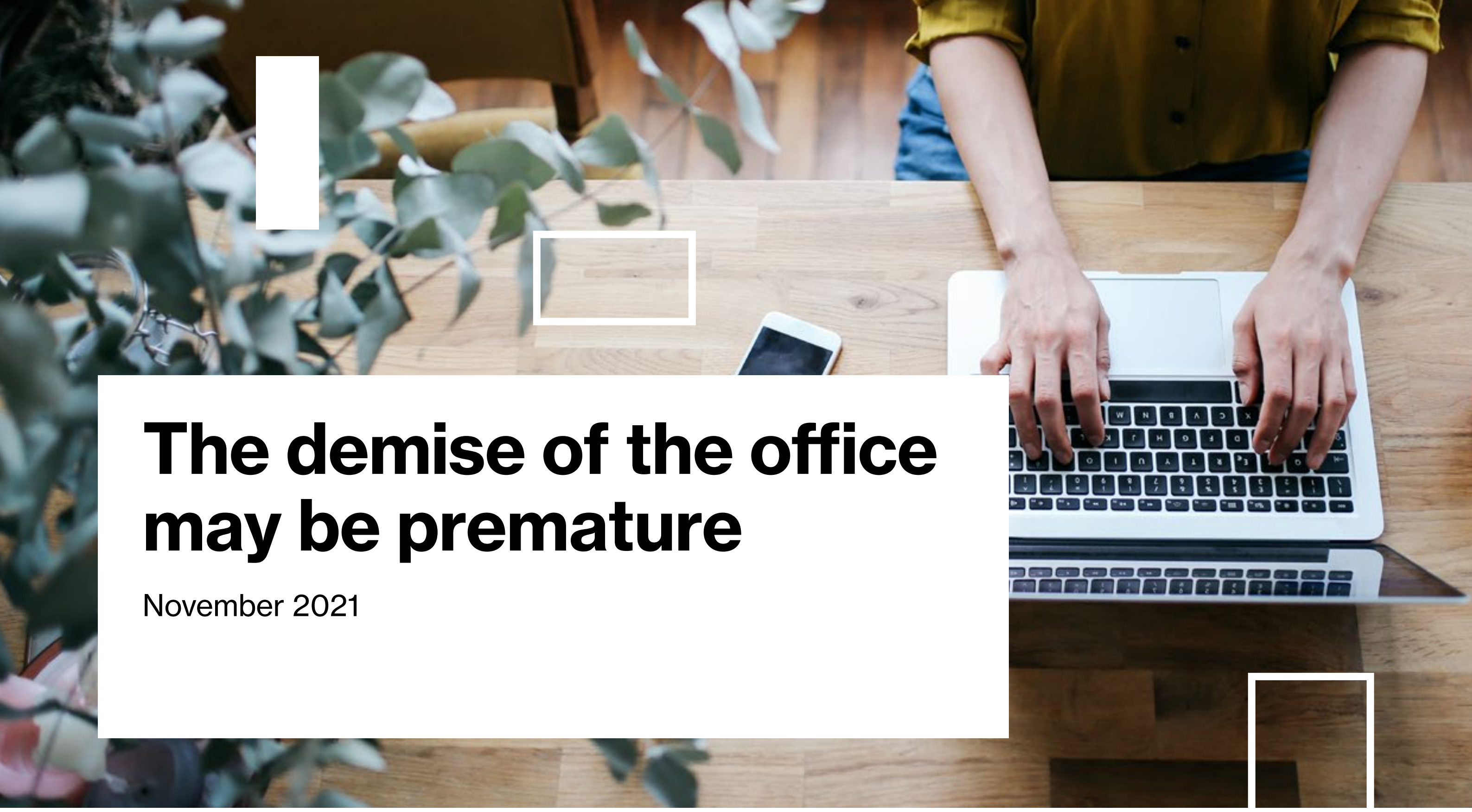

The demise of the office may be premature

November 2021

The events of the last 18 months have inevitably focused minds on the future of the office as a working environment of choice. But it's important to remember that whilst COVID-19 has had an undeniable impact on how we think about using our workspaces, this is neither nothing new nor is it confined to the office.

Offices, like every other property sector, are continually evolving. Those buildings that best serve occupier needs, whether office, retail or industrial, are those that will continue to be in demand whilst those that don't either have to adapt or become obsolete.

Real estate can offer attractive returns, good diversification and in some cases cashflow liability matching benefits. It can also, if considered appropriately, help with the journey to net zero carbon.

Location remains fundamental to an investment's future performance outcomes and its importance should be re-emphasised, especially in the context of climate risks, alongside re-lettability and income quality.

Real estate investors should now take a fresh look at:

1. The place real estate (especially offices) has within a broader real asset portfolio
2. Environmental considerations (e.g., in terms of emissions)
3. How investment managers evaluate the risks and opportunities of buildings being underwritten and acquired, and the approach to active asset management.

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Environmental impact considerations

In our recent paper 'ESG in Real Assets' we discussed the need to integrate ESG into the investment process in order to seek more resilient, sustainable and successful long-term outcomes. We also introduced the concept of peril mapping, used to assess an asset's risks (and potentially opportunities) from the impact of climatic change on an investment's future outcomes.

The UK Green Building Council calculates that the built environment contributes around 40% of the UK's total carbon footprint[1].

So, if we are to invest in a sustainable future, we should focus on those buildings that are likely to contribute the least emissions or, to invest in those where the scope to reduce emissions is greatest. Whilst new buildings are the most efficient, around 80% of buildings likely to exist in 2050 have already been built. So, the focus should be on what to do with existing stock as much as creating new. What risks and opportunities do existing buildings present to the end saver?

It is possible that a three-tier market develops for real estate assets (particularly offices):

1. New buildings that have already had energy efficiency/net zero built in by design
2. Buildings 10-15 years or so old that may prove to be uneconomic to convert to carbon efficient standards and hence may become less popular to occupiers
3. Older buildings that still represent a good option to tenants (e.g. in terms of, location and floor to ceiling height etc), that can be economically converted/ refurbished or redeveloped into the office of the future.

We contend that, the biggest emissions impact might be on tier 2 assets, although these may not be as economical to upgrade as those in tier 3. Both tiers could face significant headwinds and potentially deliver poor investment outcomes unless there is an active approach to asset management and engagement between the different stakeholders.

However, solutions do exist. Anecdotally Microsoft[2], for example, made considerable strides in making its existing estate (in Seattle) more energy efficient by repurposing its existing systems to bring about energy savings of around 10% per annum. They did this by using 'big data' collected from the third party systems they were already using within their buildings. The cost of doing this was a fraction of the c. US$60m they estimated it would cost to retrofit and integrate new systems into their estate. Big data coupled with emerging technology (PropTech) could work together to improve how buildings are managed and lessen the environmental impact.

Occupier needs for the office

Occupiers need to attract and retain talent and the office environment is a key aspect of this. One of a firm's biggest costs is its workforce. As a result, it seems entirely logical that the HR department should become more involved in assessing the needs of its workspace. Attracting and retaining the right talent will be harder in the future as location becomes less of a constraint. Being more open to the needs of a more inclusive and diverse workforce should also play a major part in this process. So, providing flexible workplaces that cater for the needs of a more diverse group of talent should be in the forefront of building designers' minds. Using technology to make best use of this space to enable employees to work efficiently and productively, whilst also reducing energy needs, is going to become more important to the bottom line. For example, linking building energy systems to the workforce diary system will enable the office to learn when it needs to adjust the temperature to best suit the number or people physically in the building.

Employee needs for the office

People need to socially interact and whilst different professions will have differing needs/working environments, the desire to have social interaction has become very evident during the past 18 months.

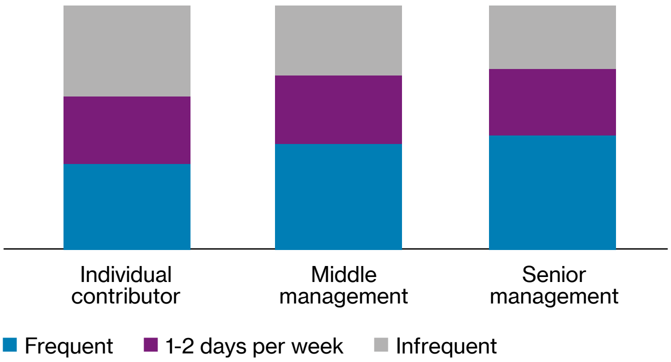
To share ideas, to network, to train and to collaborate may be better served in a physical environment. However, not every task needs to be done from an office and it is quite likely that people will adopt hybrid working in the future.

Whilst working from home is convenient and, in many cases, efficient, the need to connect is powerful.

But, does working from home add to or detract from overall productivity? The answer is not straightforward and might depend on the task being undertaken. In its report 'Are Offices Dead?', CIM Group, included an example of IBM. In 1979 IBM launched its Work From Home programme. By 1983 around 2,000 employees were taking advantage of it and by 2009 that had expanded to around 40% of the company. During this time, IBM shed about 58 million square feet of offices saving c. US$2 billion. However, in 2017, IBM ended the programme on the grounds of seeking to improve productivity and collaboration. IBM believed that face to face collaboration improved innovation.

[1] www.ukgbc.org/climate-change/
[2] https://blogs.microsoft.com/green/2013/07/09/microsoft-brings-smart-buildings-to-seattle/ and www.greenbiz.com/article/seattle-microsoft-team-bring-energy-efficiency-downtown and https://cloudblogs.microsoft.com/industry-blog/manufacturing/2017/04/18/energy-smart-buildings-use-iot-reduce-electric-bill/

Figure 1: **Post-COVID-19 preferred office attendance by level**



Source: Experience Square Foot, Cushman & Wakefield, July 2021

Working in a physical office is likely to also be impacted by the role and seniority of the individual coupled with child and other care needs. Younger employees are more likely to favour the office as a centre of learning and collaboration as well as being a social hub. More senior employees may also prefer the office in order to train and manage staff and may have less care-giving pressures and more disposable income for entertainment and would benefit from a more central location. Those in the mid stage of their careers, may prefer to work from home as they are more likely to have pressing child and other care needs and less disposable income.

There are pros and cons of working from home (compared with working in an office) as outlined by Metrikus & Re-Leased in its 2021 report, 'Return to the Office: The Future Now'. In summary *Figure 2* lists what these could include.

So, it is reasonable to expect that the future is likely to be a hybrid one where employees use the physical office for collaboration, culture/team building, mentoring/training, meetings etc and work from home when a physical presence is not required accepting that some meetings/training activities can also be productively run remotely.

Saving the cost and wasted time of commuting is a clear benefit as is being able to recruit from a wider geographic area not constrained by location. But this has to be weighed up against the benefits of working together and the desire, especially for the young, to work in a vibrant and dynamic environment where they can also enjoy social activities after work. Inevitably is likely to have an impact on other sectors too, like retail and leisure and, of course, some businesses are better suited to staff working together than remotely, whilst for others the reverse is true.

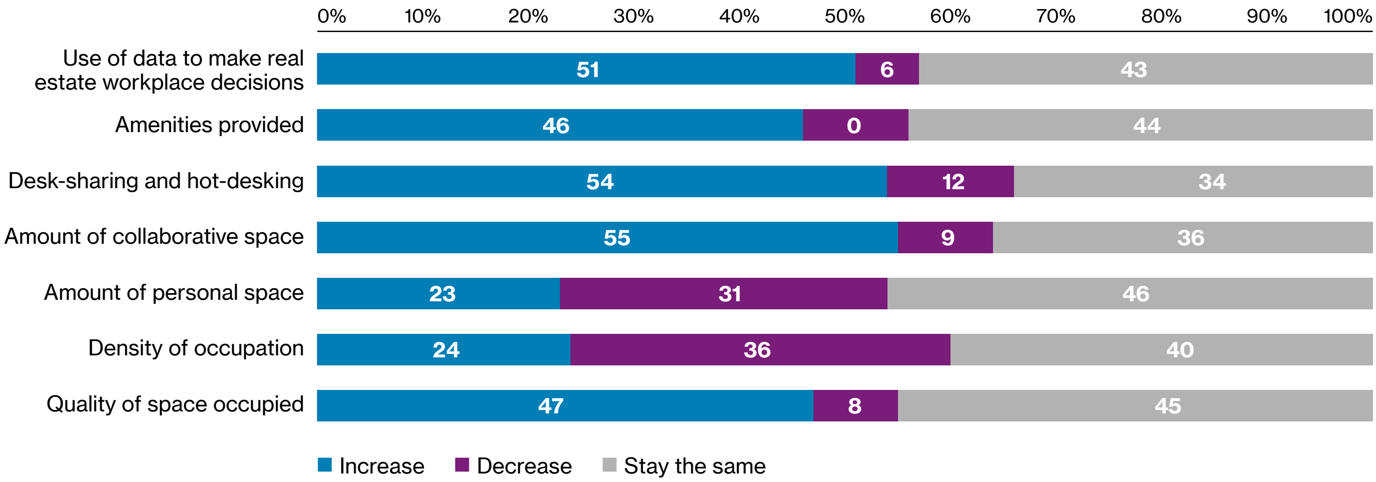
We believe that a hybrid model will help facilitate an acceleration of a more inclusive and diverse working environment beyond just widening the general talent pool.

Meetings can be more inclusive when run virtually allowing everyone to participate, especially for those who might find engagement in a face to face/physical meeting more challenging. As a result, the hybrid model, when aligned to a more inclusive and diverse culture, should lead to improved investment decision making especially if the decision-making participants are more cognitively diverse as well.

Figure 2: **Pros and cons of working from home vs working in an office**

	Working in the office	Hybrid model	Working from home
Positives	Collaboration Networking Learning from others Clear separation of home and work Culture Better facilities/tech Social interaction/mental health	Increased talent pool Empowerment Autonomy Flexibility Mental health Saves cost of commuting Less time commuting	Flexibility Custom/own environment Ease of care-giving (e.g. childcare) No commute Money saving Location independence Positive environmental impact
Drawbacks	Commuting More expensive Rigidity of working hours Distractions and interruptions Less privacy Less flexibility Constraints on care-giving (e.g. childcare)	Potential confusion over days in office Difficulty in getting whole teams together Lack of routine may not suit everyone Ensuring a desk is available when needed	Blurred lines between work and home Inadequate workspace and facilities Distractions from family members Communication/tech challenges Loneliness/mental health Motivation can be harder to sustain Reduced supervision and collaboration Less career progression opportunity

Figure 3: **Survey responses of how the workplace is likely to change over the next 3 years**



The June 2021 edition of (Y)our Space by Knight Frank[3] suggested real estate remained of strategic importance to businesses. But the focus is evolving with *Figure 3* above illustrating how priorities are likely to evolve over the next 3 years.

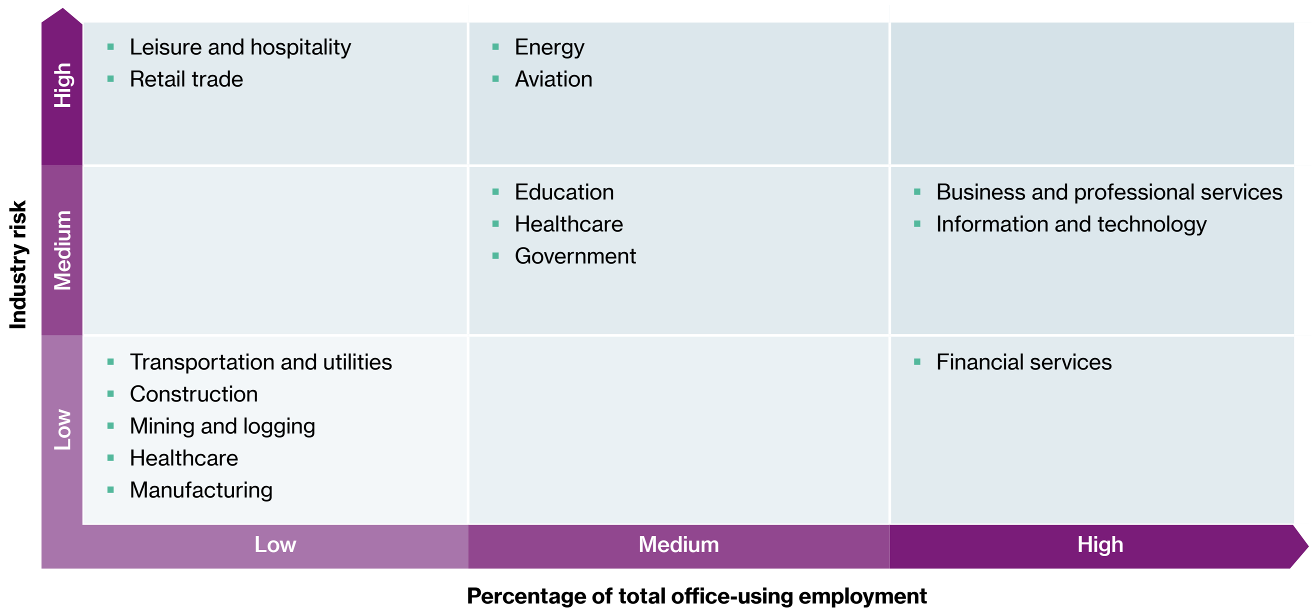
Future proofing our workplaces

Making buildings efficient and flexible to allow for changing work patterns and the need for collaboration, as well making them far more energy efficient, should be key priorities for all asset owners and managers. Much can be done easily and without much cost, through engagement with owners and tenants alike. But some aspects might require more innovative thinking. Like the repurposing of existing technology or through the introduction of more innovative 'PropTech' solutions utilising both 'big data' and 'Artificial Intelligence' (AI). Some activities might require specific tenant consent/engagement, whilst others might be limited to areas where the landlord has control. Either way, the need for investors, landlords and tenants to all work together to innovate will be necessary if our buildings are going to remain viable into the future in order to meet net zero aspirations.

Investor considerations

But what does this mean for space requirements? The extent a person can work from home will depend upon individual circumstances, available facilities and on the business type. JLL in its June 2020 report on the subject illustrates this and how this relates to the risk to the office[4] (see *Figure 4* below).

Figure 4: **Office demand matrix**



[3]Knight Frank, (Y)our Space Survey, Flash Survey Findings from the 2nd Edition, June 2021
[4]JLL, The Future of Office demand, June 2020

Picking the right asset in the right location with the flexibility to support occupiers' changing needs will become even more important than in the past.

Adaptability will be a key focus as technology continues to impact us all. This and the drive for a lower carbon footprint will impact how we travel, how we communicate, how we connect and how and where we work, shop and enjoy ourselves.

So, what will be the impact? Some commentators believe demand for offices will fall by 5-10% over the short to medium term while others believe the drop to be greater. Few believe demand will increase. Future returns will, of course, relate the interaction of supply (of appropriate accommodation) and demand. There is an argument to suggest that supply could fall because of the demand for net zero carbon. Could this balance out the work from home effect?

Landlords/investors will need to remain focused on occupier needs to provide sustainable opportunities for investors both in terms of space utilisation and viability as well as in terms of energy efficiency. Far from being a period of time we should be frightened of, the future presents a wealth of opportunities to move forward and benefit from the accelerated evolution these last 18+ months has facilitated.

Conclusions

We believe:

- Office demand is likely to fall but possibly by not as much as has been feared.
- The impact of the fall in office space demand is likely to be offset, in part, by the decline in supply.
- Offices will need to become more flexible workplaces offering a range of facilities and amenities to attract and retain talent.
- PropTech, big data and artificial intelligence are likely to become far more important aspects of a building's design, whether as part of new build installation or retro-fitted.
- Energy efficiency/climate risk are becoming vital when considering an investment and should be a major focus for investment managers/landlords when appraising investments.

Going forward, investors are likely to want their investments to deliver against their cashflow and sustainability requirements. As a result, we anticipate a shift towards more targeted strategies across a broader real assets opportunity set that will inevitably include more climate solutions (such as forestry) and an emphasis on an evolved approach to investment underwriting and active asset management. This approach will be more likely to deliver resilient investment performance.

So, in this context, investors that have become overly reliant on traditional core-balanced funds that have high, peer group driven, weightings to the office sector, may wish to review these holdings.

In order to ensure income is resilient we assert that the key messages for investment managers/landlords are:

- Assess investments in a climate risk context.
- Engage, engage and engage again, with tenants and other stakeholders.
- Collect and analyse emissions for buildings owned and put in place strategies to reduce them towards zero sooner rather than later.
- Consider the use of PropTech, big data and AI when putting together asset management strategies.
- Actively manage assets even those with long leases – there is always something that can be done.

We will be looking for investment managers and strategies that merge robust ESG thinking with a more inclusive and diverse culture. This should evolve from being a 'nice to have' to being essential.

The above should not be frightening. How we use buildings has and will continue to evolve and would have done in any case. COVID-19 might have accelerated the pace but the market will settle down in time with a focus on the space of the future. It is likely that only those ready to embrace and adapt to the future will succeed.

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