Real Estate Research

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The World of Work

A comparison of global office market occupier fundamentals

IN A NUTSHELL

— Offices had a surprisingly good year in 2022. Employees trickled back, occupier demand increased, and prime rental growth turned positive. Challenges are evident, particularly in the US, but the picture is better than many imagine.
— Across the regions, there is a massive difference in vacancy. Many European and APAC cities are recording shortages of good quality office stock, this is in complete contrast to the double-digit vacancy rates across most major US cities.
— European and APAC markets look much better placed for rental growth. Not without challenges, best-in-class offices in cities such as London, Paris, Berlin, Seoul and Sydney are forecast to record strong rental growth.

You may be forgiven for thinking that some people have forgotten how to wear trousers. Headline after headline for the past three years declaring that working life is now just one long Zoom call, dressed only from the waist up, in box rooms, on kitchen tables or wherever else we can find to perch our laptops – but certainly not in the office. This is of course nonsense, but no one can deny that work is changing, with profound implications for global office markets. This report examines the occupier fundamentals of major global office markets, reviewing the differences, similarities, risks and opportunities.

Return to the office

Office workers are gradually returning but to differing degrees

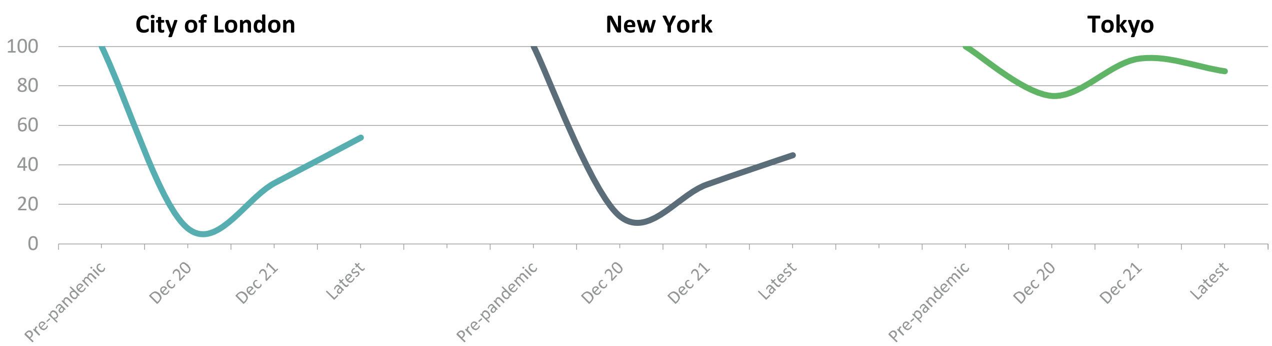
Over the past few years, the question of how many days a week we'll be in the office has become something of an obsession. Tracked almost daily, with regular updates across both industry publications and the wider press, there is still no clear answer.

Almost empty throughout the pandemic, many offices came back to life in 2022. While considerably less busy than they were, occupancy rates trended higher throughout the year as employees came back to the office for at least part of the week. In time, will things return to the way they were? To us, this looks unlikely. Hybrid working, a concept which began well before the onset of the pandemic, is now well established and, despite the possibility of a recession and corporate pushback, is here to stay.

With this in mind, many office occupiers are expected to need less space per employee. How much less is hard to say, and will often depend on local dynamics. In addition, this may not be true of all office tenants. Some may also look to de-densify, providing more meeting and collaboration space, while the clustering of in-office working patterns around the middle of the week will likely limit how much space occupiers can release.

Overall though, this trend is expected to be a drag on total office demand. So far, North Asian cities look most resilient to this change. With Seoul and Tokyo employees coming into the office throughout much of the pandemic, these cities have seen far less of a shift towards hybrid working. This may be the exception but even in Europe we see big differences in the pace and extent of return. By the middle of last year, office occupancy in the City of London was still just 30%, compared to 50-55% in Paris and Madrid.[1]

Estimate of Office Occupancy (Utilisation) Rate (Index Pre-pandemic = 100)



Source: Various broker reports, Remit Consulting, Kastle, January 2023
Note: Methodology for calculating occupancy rates may differ between cities.

Why do utilisation rates differ so much from city to city? Many have posited an answer to this question but there is no one simple answer. Some suggested reasons are below; however, it would be fair to say that these are only a fraction of the multiple considerations determining behaviours driving occupancy.

Lockdown severity

According to Savills, cities that experienced shorter and less severe lockdowns are less likely to have seen a shift towards hybrid working.[2] Cities like Paris and Tokyo (which also gained from an office-based culture) saw less of a reduction in attendance during Covid, allowing utilisation rates to remain higher, possibly becoming less entrenched.

Population density

Since the start of the pandemic, remote working has often been cited as one of the main drivers of demand for larger housing. While an option for some, there is little evidence of a permanent shift in population away from urban areas. Nonetheless, this supports the view that densely populated cities like Paris may see a greater return to the office, with employees residing closer to their place of work and living in accommodation with fewer rooms that are less conducive to working from home comfortably.

City demographics

There is evidence to suggest that hybrid working tends to be preferred by older, wealthier and married employees. A poll of 2,500 UK workers found that just over 20% of those aged over 55 years wanted to see a full return to the office, compared to half of the 18- to 24-year-olds surveyed.[3] This tallies with a PWC survey in the US which showed that employees with the least experience (0-5 years) wanted to be in the office more often, and were more likely to feel less productive working from home.[4]

[1] Savills, August 2022
[2] Savills, June 2021
[3] Totem, May 2021
[4] PWC, January 2021

Commute

There is a large amount of survey (and anecdotal) evidence to suggest that a reduction in commuting is seen as one of the more beneficial aspects of hybrid working. Be it time, cost or the general unpleasantness of rush hour travel, commuting is seen as a major determinant in the frequency of trips to the office. London in particular looks exposed to this, with commute times and public transport costs as a share of income reportedly some of highest in the world.

Indicative Office Occupancy Risks (Unranked)

Source: DWS, OECD, Google, Savills, Financial Times, Various broker reports, Silverdoor, As of January 2023
Note: Indicative. Green = positive driver of office utilisation rate, orange = neutral, red = negative. Cities sorted alphabetically by region.

Occupier demand

Office take-up gained momentum in Europe and APAC, with corporate occupiers tending towards better space

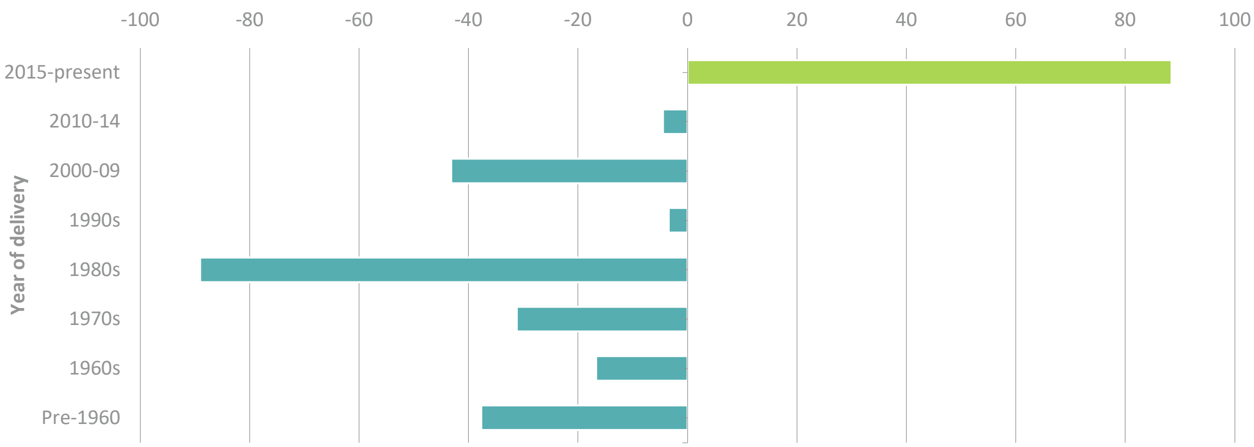
Despite ongoing concerns over hybrid working, demand for office space was surprisingly robust in 2022. Take-up rose sharply across Europe and APAC, pushing net absorption firmly into positive territory. It seems likely that some of this increase was the result of leasing decisions delayed during the pandemic period, but many were surprised by the upswing, particularly given the darkening economic outlook during the latter part of the year.

The US was an exception to this, with net absorption expected to have been negative for the third year in a row. Despite a continued recovery in leasing activity, record lease expiries and a significant reduction in renewals resulted in occupiers shrinking their overall footprint, often in exchange for higher-quality space.[5]

This shift towards higher-quality space is a common feature across many global office markets. Changing occupier needs, regulatory requirements, talent retention and net zero goals are all manifesting in a shift to quality. While not necessarily new, there are signs that this trend is gaining momentum. Last year over 80% of all large leasing deals in New York[6] and 90% in the City of London[7] were made in grade A buildings.

[5] JLL, October 2022
[6] Costar, January 2023. Note: Leases over 25,000 square feet
[7] Savills, September 2022. Note: Data until end-August 2022

US Office Net Absorption by Year of Delivery (Million Square Feet, March 2020 to Q3 2022)



Source: JLL, October 2022.

We mustn't just extrapolate the positive from last year into 2023. As a typically pro-cyclical sector, the office market is likely to be exposed to the expected slowdown in global economic growth. Although we're not anticipating major job losses, the start of this year has certainly seen a wave of such announcements across finance and technology.

More important is the trend outlook beyond 2023. On balance, we expect the shift to hybrid working to reduce total space requirements, as occupiers take a smaller amount of better-quality space. It's important to stress though, that this doesn't mean office demand is in terminal decline. Once the sector has been through a period of adjustment, with lower levels of space per worker, we anticipate that continued office employment growth will support an acceleration in demand.

The extent and the duration of this adjustment will in part be determined by current levels of office density. US markets look a little more vulnerable here, but not as much as some would believe. Despite the reputation for cubicles and private offices, the average office space per worker in New York was similar to London, and below that of Paris and Tokyo, according to an analysis by Cushman & Wakefield in 2017.[8]

Supply, vacancy, and rental growth

Divergence between regions, with almost all US cities seeing double-digit vacancy

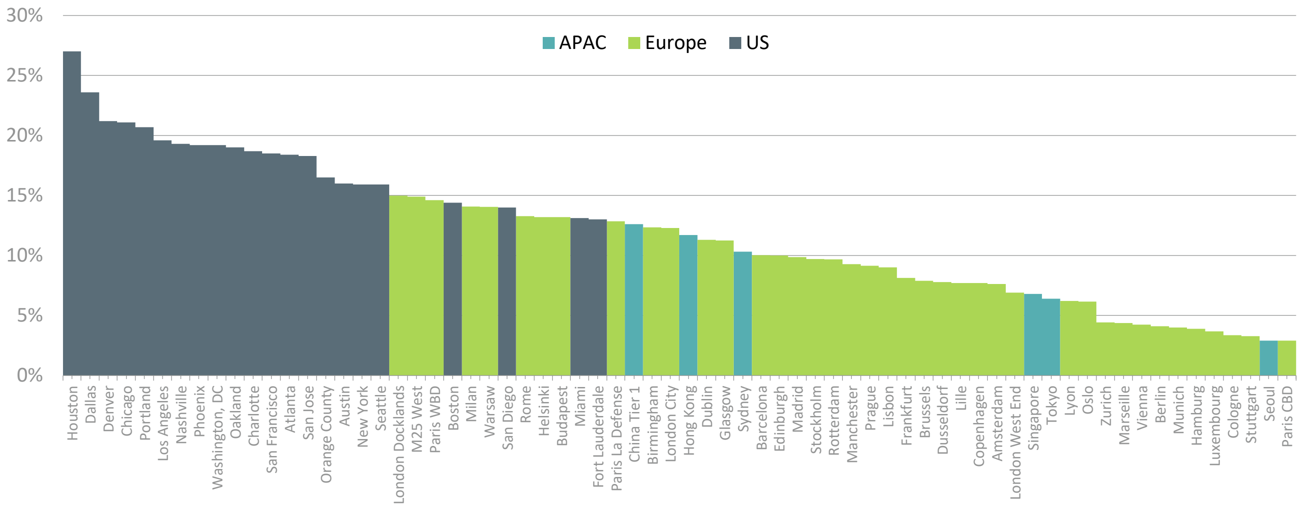
By far one of the greatest differences between markets is supply. From the lows of Seoul and the Paris CBD to the highs of Houston and Dallas, vacancy rates, across the major global markets that we cover, range from a mere 3% up to an enormous 27%. Putting aside ongoing structural changes, this alone is enough to explain a diverging outlook across global markets.

Since the start of the pandemic, no region has been immune to rising vacancy, although the US stands out. Having been a high vacancy market for the past two decades, the average vacancy has jumped seven percentage points since 2019, sitting near 20% at the end of last year. Without exception, the 22 US office markets we cover are all showing vacancy rates well into double digits.

This sits in clear contrast to Europe and APAC. While there are high vacancy markets, notably the purpose-built business districts of London Docklands and Paris La Defence, as well as some Australian cities, on average vacancy rates sit at just 7% in Europe and 9% in APAC.

[8] Cushman & Wakefield, November 2017

Major Market Vacancy Rate by Region



Source: DWS, Various broker sources, PMA, January 2023.

A high office vacancy rate in the US is not unusual. Having doubled during the early 2000s dot.com crash, the average vacancy rate has been in double digits for over twenty years. However, why have these levels persisted, particularly given the relative strength of the US jobs market?

One obvious culprit is development. While the US may have recorded negative net absorption last year, as a percentage of stock, demand over the past twenty years has been broadly similar to that of Europe. The same cannot be said for net new supply. Average annual net development in the US as a percentage of stock has been around 15% higher than in Europe over this period, rising to over 60% over the past five years.[9]

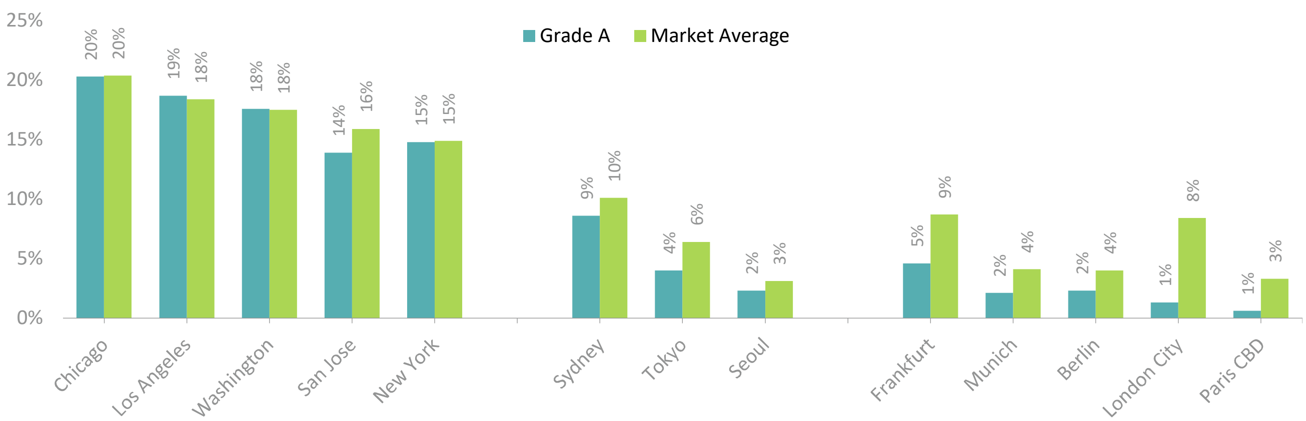
Development activity has been far higher in APAC over the past two decades, reflecting the emergence of Korea and a period of exceptionally strong development in Singapore between 2010 and 2013. Nonetheless, the strength of economic growth and job creation in these markets has helped prevent a surge in vacancies. Over the past five years, development has also moderated, falling to around half the 20-year average.

Given differences in definition, we need to be careful when comparing estimates of good quality “grade A” vacancy across markets. Nonetheless, the data shows that following the large amount of development over recent years, there is certainly no shortage of this type of stock in the US.

This is not the case in Europe and APAC. Not only has a lack of development kept down vacancies, but it has also led to a notable shortfall in the availability of good quality stock. Grade A vacancy in the City of London and Frankfurt is well below the market average, and in the likes of Seoul, Paris, Munich and Berlin there is almost no high-quality space readily available to lease.

[9] DWS, PMA, CBRE, January 2023

Vacancy Rate by Location and Building Quality (Q3 2022)



Source: DWS, JLL, Knight Frank, PMA, Various broker data, January 2023
Note: Sydney Grade A reflects the "Premium Grade" category.

We foresee no respite from these shortages in Europe. With question marks over hybrid working, expected recession, higher construction and financing costs, and the recent fall in values, development pipelines are increasingly thin. Not only this, but we also expect to see stock being withdrawn from the market. Whether the result of changing occupier requirements or regulatory requirements – such as minimum EPC ratings – there is a high possibility that poorly located, older, commodity office stock will no longer be lettable. Our latest European forecasts show net completions turning negative before the end of the decade, and given the vacancy picture, we anticipate this could allow for a swift resumption of prime rental growth from 2024, with best-in-class, next-generation space, in cities such as London, Paris, Berlin and Stockholm recording rental growth well above inflation.

This is less the case in APAC. Tokyo is experiencing something of a building boom, with 2023 forecast to see one of the highest levels of net additions on record, weighing on rent growth well into the second half of the decade. The pipelines in Australia and Korea are much more modest. Having seen some of the largest rental falls during the pandemic, Sydney and Melbourne are expected to be some of the best-performing globally in terms of rent growth over the coming years.

The US should experience some respite from oversupply. Not only is the current wave of deliveries starting to wane, but net additions should also moderate as demolitions and conversions remove obsolete stock from the market.[10] This is not to say that the US market will see the return of competitive tension any time soon. Overall, we project rents to fall by an average of 0.2% per annum over the coming five years. Nonetheless, with increasing regulatory and occupier pressure pushing for carbon neutrality and for new construction to be of higher LEED standards, this does suggest that best-in-class buildings may be some of the first to recover.

Conclusion

Differences, similarities, risks and opportunities

The office remains an integral part of business operations, but there is no denying that the way we work is changing, and with it the role of the office. Understanding this will be an important element when judging how to approach investment in the sector. However, this is not enough. As shown in this report, there are big differences between cities, from hybrid working practices to more traditional supply and demand dynamics.

[10] JLL, October 2022

As we look to the year ahead, the immediate outlook for offices is challenging. Tending to move in line with the economic cycle, the prospect of recession and job losses suggests rental growth could be in short supply. Even beyond this year, the sector will be tested, and more than ever a full and detailed understanding of local market conditions and asset-level dynamics will be a necessity for any investment.

It may be some time before some investors are confident enough to deploy capital into today's high vacancy US markets, but in many parts of Europe and APAC, the sector already looks well positioned. Changing occupier preferences are meeting a lack of good quality space and a diminishing pipeline and should this continue, we strongly believe that best-in-class buildings in cities from London to Seoul, Paris to Sydney, will be well positioned for performance, creating opportunities for investors to refurbish well-located but aged buildings into the next generation of offices.

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