The failure to contain the Covid-19 pandemic has resulted into more than 80 countries to be in some form of lockdown at the time of writing. The draconian constraints on movement enacted by governments remain the most realistic option to support the fragile global healthcare system. However, and amongst other things, the shutdown has triggered massive losses for companies and pushed millions of people out of work. In the meanwhile, many companies have also adopted extensive homeworking procedures to keep business running and limit the impact on income.

Within this context, this short note attempts to provide some initial answers to the several questions surrounding the outlook for European offices.
All economic crises have unique features but there is enough commonality between them to review the events of one particular downturn in order to find some guidance to the future. The best example for a comparison with today’s recession is the Great Financial Crisis (GFC). This is for two reasons. First, the property data sources are excellent for this period, as opposed to previous recessions. Second, the GFC was truly a global recession and had a very severe effect on the property markets of most of the advanced countries.

The rental peak for European offices was reached between Q2 2007 and Q3 2008, the time of the Lehman Brothers crack. To find the trough of the market, we have used a cut-off period at Q2 2010, as rental values in most markets had already troughed and we needed to separate somehow from the euro-crisis period. The length of time needed to reach the trough was different from market to market, ranging within 3 and 8 quarters, and averaging 5.5 quarters across all markets. Peak-to-troughs rental values averaged 14%, while the year-on-year decline between Q3 2008 (coinciding with the Lehman crack) and Q3 2009 was around 11%, equivalent to the largest part of the correction. Two factors were quite important to explain the sharp rental decline: a) relatively high vacancy rates and b) significant amounts of speculative office space under construction.

While it is always important to look at history, formal statistical analysis, based on macroeconomic data, can only help that much when trying to make accurate predictions about the consequences of an economic shock. There is some merit, on the contrary, to investigate what the commonalities and differences are from the viewpoint of the supply side. This is because benign supply conditions have the potential to mitigate a large part of the negative rental pressure generated by lower expected future demand for office space.

Exhibit 1 shows the difference between vacancy rates for Q3 2008 and Q4 2019, the latest observation we have on record. A negative value means that the current vacancy rate is lower than in 2008. The chart shows that most markets are in a better position in comparison to the previous crisis. In some cases, the difference is rather significant as for Amsterdam, Dublin and the main German markets. Moreover, although data is not shown here, office availability in central areas in virtually all European office markets is currently rather tight. All other things being equal, lower starting vacancy rates should translate into lower downward pressure on rental values.

1 Only few markets troughed later than this date. Those were the highly volatile and supply-ridden markets of Dublin, Madrid and Barcelona.
The evolution of future supply will also have an impact on the course of rental office values. While speculative space has recently increased, it is still below the level reached in 2007. Specifically, the average speculative space under construction in Europe at the height of the GFC crisis was 2.6% of stock, while it is currently around 2%. It needs to be said that, while some markets are relatively disciplined in terms of future building, others are featuring some worrying levels of construction. Those markets include the main CEE cities (Warsaw, Prague and Budapest), Dublin and La Défense in Paris. As a corollary, we expect a number of planned schemes to be postponed or cancelled altogether.

The above analysis is not at all trying to minimise the consequences of the current crisis. However, and all other things being equal, it is fair to say that office markets are in a much more robust situation when compared to 2008, both in terms of current and future availability. This consideration will prove to be vital to measure markets health beyond the short term.

To help our understanding of the current situation, we have developed some initial short-term forecasts, based on historical evidence and our view of how demand will evolve during 2020. The average European office vacancy rate was 8.6% in 2008, then it shot up to 10.7% at the end of 2009, roughly a 210 basis points increase. The equivalent number was 6.1% at the end of 2019. Based on our preliminary results, we forecast the vacancy rate to be 6.9% at the end of this year.

As a result of the previous analysis, we expect the downturn on office rent to be much less significant than during the GFC crisis. Our assumptions are based on a) the lower impact of future supply and b) the lower levels of the vacancy rates, which are consistent with higher rental values resilience. The detail of the forecast is shown in Exhibit 2. As a result, at the time of writing, we estimate that prime rental decline will be around 2.4% on average this year, vs. 9.9% between 2008 and 2009. We should stress that this analysis refers to headline rents. We expect incentives to become more significant across the board, and, mostly in the markets where fundamentals are weaker. This should result in an increasing gap between headline and effective rents.

EXHIBIT 1: DIFFERENCE BETWEEN OFFICE VACANCY RATES IN 2008 AND 2019 (%)

Source: BNP Paribas Real Estate

2 Numbers may slightly differ from other BNPP RE reports. This is due to the choice of a slightly different markets sample.
Our forecasts are contingent on the current estimate of the end of the lockdown in different countries, based mostly on the approximate indications provided by different European governments. We see this process unfolding in waves, over the next months.

To sum it up, and based on a mix of historical evidence and current assumptions, we expect this downturn to be gentler than the previous one. Clearly, market uncertainty is still too high and we expect our estimates to evolve over time. However, rental downturns usually tend to be fast, which means that the market trough could be attained more quickly than expected. As a result, and based on a correct market assessment, investors have a significant chance to create value by buying in a still bearish but improving market.

EXHIBIT 2: PRELIMINARY FORECASTS ON PRIME OFFICE RENTAL VALUES IN EUROPE (%)
The Covid-19 outbreak has significantly changed our professional life and these days our home is the new office and internet is the new meeting room. For some people and companies it was an easy transition, as they already had a flexible working culture and had invested in technology for some time. For others, the cultural shift was more challenging. In the meanwhile, homeworking is helping to keep business running and limit the impact on income, therefore preserving jobs relative to the overall impact on GDP.

At the moment, every company around the world is occupied to make sure business continuity is guaranteed. However, when the lockdown is progressively released, we need to think how the shape of the “new normal” will be. These considerations are important for both investors and tenants. It is reasonable to think that until a vaccine is created, social distancing rules will likely require some kind of rostering systems, different rotations and changes in the way we access space. All of this has implications in terms of increased security, monitoring compliance and investment in technology.

There exist two opposite views with reference to homeworking and its relation to current events.

The first one argues that this experience will make homeworking much more acceptable and lead to a rise in its activity once we move back to something more normal. Currently we are experiencing a mass experiment in homeworking. Successful firms are those who best cope with this event – in terms of having the right IT & flexible business practices in place. This is likely to create a potential survivor bias: to do well in the future you will have had to make homeworking function in the current situation so to result in a successful experience. The normalisation of homeworking, it is argued, will result into its practice becoming a much greater component of business life. There also is some evidence that most employees appreciate the increased time flexibility and the suppression of commuting, as pointed out in a recent survey conducted by BNP Paribas Real Estate. As a result, it is said this will lead to reduced demand for office space as people work at home either full time or, if part-time, then they will hot-desk. There are also expected to be consequences for transport companies as we reduce business travel, both for meetings and for commuting.

Flexible-office providers had positioned themselves as the logical alternative to full time office space, benefiting from uncertainty, but the particular nature of this crisis, i.e. social distancing, has seen businesses leapfrog this option.

The other camp argues that this experience is proving very difficult for many people. The wealthier and more highly skilled are the most able to cope, having higher-end equipment and home space to operate in a dedicated quiet environment. Many others are struggling to work in housing that does not provide
such facilities. Moreover, while the school closures are not a long-term feature of homeworking, the current situation highlights the issues of trying to be flexible for parents of young children. Also, while younger workers in cities are often sharing accommodation, which is an acceptable short-term or occasional option, this is less good if most of them are at home on a more regular basis. Finally, the already-quoted BNP Paribas Real Estate survey reports employees saying that the blurring of professional and private life is a cause of concern. Reduced employees collaboration might also be an issue. As a result, there exists a significant risk of extensive co-working resulting in lower output and productivity. As a corollary, the frustration deriving from lower performances at work will also reduce employee satisfaction.

Different arguments result in a mismatch of costs and benefits. There are clearly identifiable and measurable benefits in reducing property and travel costs, both in financial terms and in time. In contrast, the benefits of face-to-face meetings, of interaction with work colleagues are much more difficult to measure but, in our opinion, are very important. Space at work is conceived to maximise the working experience and to enhance productivity. Moreover, efficiency is mostly the product of team effort and we believe physical interaction has still an edge over other solutions.

Companies are now testing what works for them, and what does not. When we go back to the "new normal" we would expect people to spend more time working at home and to use the time spent at work in a more collaborative way. However, while it is fair to say that technology has enabled many businesses to carry on and we might be grateful that we can continue to work during this crisis, this does not mean we must be happy with current circumstances. For example, client presentations are working well but miss the vital ingredient of interaction, resulting into an acceptable interim tool but not a better alternative.

The knee-jerk reaction to the crisis is likely to say that the business community does not need so much office space. However, we should remember that just after 9/11 happened it was argued people would not work in skyscrapers. The same happened when it was said that tourists would avoid London and Paris after 7/7 and Bataclan attacks. We now know that all those predictions were wrong. Businesses always find a way of adapting to circumstances and this time will be the same.

This will probably require a new way of thinking about space but the office as a working destination is not going to be replaced any time soon. As a result, we do not see any massive decrease in demand for office space due to a large embracing of homeworking. If anything, as social distancing becomes the norm (resulting in lower office space densification) and, in parallel, homeworking is widely adopted, we might just discover that we need the same amount of office space.
Space per employee has reduced over the last few years as companies have pursued higher levels of space productivity. Just looking at the period since the Great Financial Crisis, floorspace per worker (FPW) in Europe has fallen by around 9%. Personal space utilisation has fallen more quickly as our measure includes shared space, which has increased, notably in meeting rooms. The detail over the long-term is shown in Exhibit 3. Although the chart shows the average change, the rate of space decline has been different across markets. Moreover, different markets show different FPW, notably this is much lower in London and generally higher in German markets.

Office space per worker reduction was already slowing down before the Covid-19 crisis. After all, it becomes more difficult to economise on space as the absolute space per worker becomes relatively small. Falls in FPW are also limited by legacy space. With fewer completions than in the past, office space is not being revamped as quickly and this is often necessary to accommodate high levels of occupancy, as it is not viable to just cram more people into traditional buildings. This is because of fire regulations, air conditioning, design issues, and other technical matters.

It has been said that the current virus outbreak has the potential to revert course for commercial office space. At the time of writing, strong focus is being applied to social distancing and stricter sanitary measures. This phenomenon clearly goes in the opposite direction of the trend witnessed over the last years. Public-health officials may increasingly amend building codes to limit the risk of future pandemics, potentially affecting standards for heating, ventilation, and air conditioning, square meters per person, and amount of enclosed space. It is still too early to figure out how much space is so dense in its overall occupancy levels.
as to cause problems with social distancing. However, some redesign of the split between personal and shared space will be necessary. In the medium-run, as the current threat recedes it is likely that most people will become less concerned about these risks, therefore buildings finding their own way to the best use of space.

All other things being equal, offices are likely to be less crammed in the future. This should just sound good news for investors, signalling that demand for office space may not keep going through the previous structural reduction over the next few years.

In turn, as long as the current concern on sanitary risk remains, companies might reconsider their strategy in terms of the overall space required, privileging cheaper, suburban buildings to more expensive, central offices as social distancing would be easier to implement in the former. However, it is not clear whether this choice would be business-efficient. Moreover, young highly-skilled staff will likely prefer more central space. Finally, and more importantly, current mass transit systems are focused on connecting large urban centres, so a form of dispersal would put a lot more people on to the road. Although public transport may be unpopular for a while, it is difficult to see how driving will become more acceptable given the climate debate.

Partially related to the issue of un-densification of space is the outlook for co-working. The rise of flexible office and co-working spaces has been supported by shifting trends in the needs and demand of both corporate occupiers and employees. While, typically, entrepreneurs and freelancers are the first clients for flex space, larger corporates have also been able to benefit from the additional flexibility that these arrangements offer. Any corporate could indeed expand the number of employees without having to commit to long-term leases by the adoption of flexible space. The flexibility provided by the co-working model in terms of short-leases is still expected to be attractive to occupiers, even after the current crisis.

The co-working model works better in some locations rather than others but is all based on similar principles. Efficient flexible-office operators profit from the fact that they are able to market their locations at two to three times the rate per square meter that could be reached under a standard lease due to achieving considerably higher densities.

Flexible-office providers are registering ratios of 5-7 sqm per employee compared to roughly 19-20 sqm per employee under standard leases. This means that even allowing for high occupancy levels, profitability might be seriously hit in the case of massive un-densification. It is too early to see how co-working companies will adapt to the “new normal”. However, the prospect of reverting to higher FPW is surely a challenge for this business model. Presumably, a few companies will suffer and go out of business, which is going to result, among other things, in a further consolidation of the co-working industry.

From the investor viewpoint, we should add that we do not envisage a collapse of the co-working business model but we expect an increase in the scrutiny of the prospects for some of these companies, which have already become significant tenants in a few European markets.

3 Numbers vary by market. Please consider this average as an approximation.
The Covid-19 outbreak begun to take a gradual toll on European investment volumes from mid-March, as most countries begun to shut down parts of their economy. Recently released data shows that most European markets saw a decent level of investment activity in Q1 2020, with investment volumes in some countries even exceeding that achieved during the same period in 2019. That said we think Q2 and Q3 will certainly see significant falls in transaction volumes as a result of the lockdown measures. While Q4 might see investors return to the market, it will not be sufficient to reverse the decline. Therefore, we see overall investment volumes in 2020 plummeting by about 45% across Europe. This is similar to the fall seen in the first year post GFC, although the market went on to decline further during the following year. We think this time round we are likely to see a swift bounce back in 2021, as the pandemic recedes towards the end of the year. The investment market is still working despite severe external difficulties, but finance is hard to get and cash is increasingly king. Those deals increasingly involve good levels of equity, and less debt, on the part of the buyer as banks tighten credit conditions. Banks are growing cautious in financing deals and are doing so with increased cost and lower LTVs. As such, cash investors are likely to predominate as opportunities appear.

Office prime yields have now reached their lowest level across Europe while, before the Covid-19 crisis, we were still expecting some further compression in the core markets. After the virus outbreak, the deteriorating outlook for the occupational markets and restrictive financing conditions will result in investors demanding higher risk premia. However, other, mostly mitigating, elements are coming into play when trying to gauge the extent of yield decompression, such as:

- The yield gap over the risk-free yield is currently in excess of 380 basis points (vs. 50 basis points in 2007), as shown in Exhibit 4
- Market fundamentals (as previously seen in this note) were quite robust entering into the global sanitary crisis
- Around €1.2 trillion of European bonds are coming to maturity this year. Some of this money is expected to be reinvested in higher-yielding alternatives, including real estate.

In this case the 10-year German Bund.
As a result, while we see a broad-based increase in prime office yields, the overall rise should not be that significant. As of today, we believe office yields should rise by around 20 basis points on average in Europe, and within a 15-30 range across markets by the end of 2020. Putting together both rental correction and yield change, we expect capital values to decrease by 8% on average this year. If the economy recovers as expected in 2021, we should anticipate some yields stabilisation.

What does all this mean for investors having exposure to the office sector? If our forecasts are sound, long-term performance should not be significantly affected by the correction. As always, we stress that proactive asset management should be applied to maximise income returns. During an economic crisis, it is vital to develop a strong tenant communication strategy, in order to monitor tenant distress.

On the other hand, a price reduction also means that opportunities become available. As it was pointed out before in this note, downturns tend to be quick, so that pauses in investment demand quickly give way to sudden increases in activity when investors perceive market confidence as turned. As a result, we would suggest investors to stay close to the market and scout for off-market opportunities.