Evolution rather than revolution: Covid-19, remote working to have uneven impact on Europe's office real estate market

Restricting people to their homes to contain the Covid-19 pandemic has changed how they shop, socialise, study and work. Some changes may prove long term, with far-reaching repercussions for real estate. The severity of the impact on office property is less clear.

The Covid-19 impact on office space could markedly diverge across different parts of Europe. While the repercussions in some countries might be limited due to pre-pandemic remote-working trends, the impact might be stronger in countries with significant office space under construction, more pronounced vacancies and lower prevalence of home working before the pandemic started.

Remote working will also have an uneven impact across buildings types: high-quality, modern and flexible premises whose owners can more easily adapt to the new market requirements will remain in demand – for three reasons.

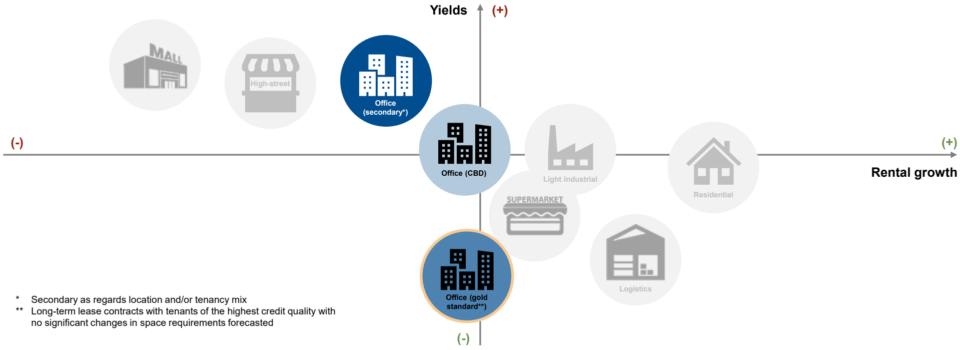
First, the pandemic has accelerated a pre-existing tendency rather than created a new trend toward more flexible working arrangements for white-collar staff.

Secondly, in some cities and regions such as the Nordics, working from home was relatively common pre-crisis. Therefore, any shake-up of the office property market is bound to be less pronounced there than in places where the pandemic leads to a more fundamental shift in working patterns.

Thirdly, there are potentially powerful forces which will limit, if not offset, the impact of remote working on demand for office space. Prestigious offices will remain important for corporate branding and as a place to meet clients and business partners as it was pre-Covid. Employers will also focus on improvement of the company's working environment, possibly with a shift away from personal, cellular spaces to more collaborative space. As many employers will likely insist on regular office attendance for some and perhaps all staff, they will encourage it with more spacious working, meeting and communal areas, not least to conform with expected stricter coronavirus health and safety measures. Employers will also continue to rely on smart, modern, comfortable offices to recruit and retain skilled staff

In addition, the European office market was characterised by greater demand than supply before the pandemic struck. The trend towards more working from home might simply bring demand more in line with supply in the medium term.

Figure 1. Main trends 2021 (focus office)



Source: Scope Ratings

Analysts

Rigel Patricia Scheller
+49 30 27891 319
r.scheller@scoperatings.com

Related Research

European real estate credit outlook 2021: overall resilience; pandemic's uneven impact hurts retail
January 2021

Logistics real estate: safe-haven status grows. Nordic sector reveals lure, risks for investors
December 2020

Swedish real estate sector sets pace for hybrid funding in Nordic region; investor scrutiny grows
December 2020

What will the European CRE sector look like when the dust settles?
May 2020

European Logistics CRE: outdated assets won't ride growth momentum
April 2020

Scope Ratings GmbH

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: RESP SCOP

Remote working spreads unevenly before Covid-19 crisis

Remote working is not a new trend

Working from home is not a new phenomenon in Europe but it was a slow-burning trend before the pandemic. In the EU, only around 5% of employees worked from home in 2010, a percentage that remained constant until 2019. However, the share of employees working from home at least once a week did increase from 12.5% in 2010 to above 15% in 2019, according to Eurostat data.

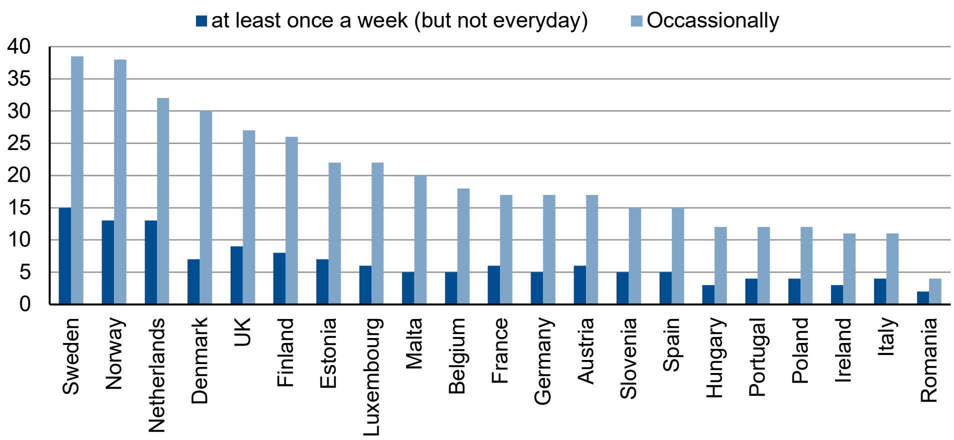
Working from home was much more pronounced in the Nordic region. More than 30% of employees worked from home for at least part of the week in Denmark, Norway and Sweden in 2019, according to Eurostat. In contrast, rates were far lower in parts of Eastern Europe, at just 10% in Hungary and Poland, for example (**Figure 2**).

Uneven spread of home working across Europe

The different industrial profiles of European countries partly explain the uneven prevalence of remote working, since not all tasks can realistically be done remotely. The size of a country's knowledge-intensive sector tends to determine the take-up of remote working. In Sweden, a country with a well-developed information and communication technology (ICT) sector, more than 60% of ICT employees had the option to work from home in 2019, according to JRC calculations.

Working culture also plays a role. Flexible working has been embedded in Finland's labour market for over two decades, based on a deep-rooted culture of mutual trust, a focus on family-friendly work policies and flatter hierarchies[1].

Figure 2. Prevalence of remote working in European countries – 2019 (%)



Source: Eurostat, Scope

European office market buoyant pre-crisis

Office demand outweighed supply pre-pandemic

The office real estate market in Europe experienced record take-up levels of more than 12 million sqm in 2018 and 2019, with office vacancies running at an all-time low of 5.8% at the end of 2019. Robust demand and limited supply exerted upward pressure on rents and pushed vacancies in some cities to unusually low levels.

Low vacancy rates in German, Nordic cities

Vacancy rates were particularly low in Germany – Berlin 1.5%, Munich 2% – in Paris 1.6% and in Nordic capitals. In Stockholm, the vacancy rate fell to 5.5%, 1.5pp below the level of 2017. In Oslo, the vacancy rate dropped to 5% in 2019, the lowest level since 2008. In Helsinki, the vacancy rate has declined since its high of 13.5% in mid-2017 and was 11% by the end of 2019. While high compared with other capitals, the building pipeline for the next few years is thin, with only 42,000 sqm of offices under construction.

[1] https://www.eurofound.europa.eu/observatories/emcc/erm/legislation/finland-working-time-flexibility

Overall, Europe's tight office market reflected the years of sustained economic growth after the global financial crisis in 2008-09, leading to declines in unemployment across Europe and steady increases in economic activity in metropolitan areas.

Near-term impact of Covid-19: public health measures take their toll

Health measures force people to work from home

The dramatic impact of the measures to contain the Covid-19 pandemic have inevitably fed through to working habits and demand for office property in Europe and the rest of the world.

The first round of lockdowns resulted in about 50% of the workforce in Europe working from home[2]. Continuing restrictions have ensured that offices in many countries have been left empty.

Occupiers postpone decisions, reassess office needs

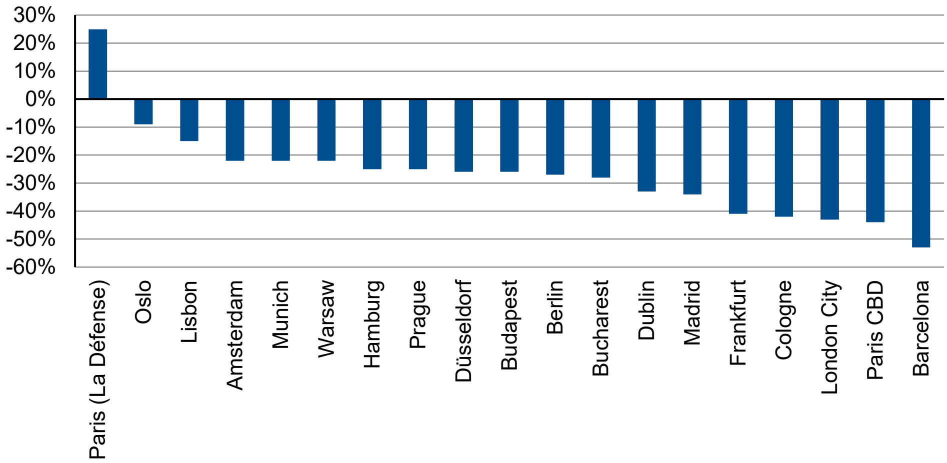
Rental negotiations have stopped, as occupiers have adopted a wait-and-see approach to assess their long-term requirements for office space if, and when, the pandemic is brought under control. Working from home is currently widely endorsed by governments as part of their coronavirus-containment strategy.

The uncertainty regarding the future of the office market has pulled letting activity down by 31% against the five-year Q1-Q3 average – according to Savills.

Northern Europe has been resilient

Northern Europe and some central and eastern European countries have still proved relatively resilient. The biggest metropoles such as Paris (the central business district rather than La Défense) and London suffered the most in terms of occupier demand (**Figure 3**) as the authorities imposed strict lockdowns and other measures in March and April last year. In the case of London, the office market faces not only the remote-working challenge but also the strong competition from flexible office providers[3] and Brexit.

Figure 3. European office property take-up (Q1-Q3 2020 % change vs 5Y average)



Source: Savills Research, Scope

Vacancy rates rise, though impact uneven

Pandemic-related measures increased vacant space across European markets, rising to 6.3% as of Q3 2020 (0.5pp higher than in December 2019).

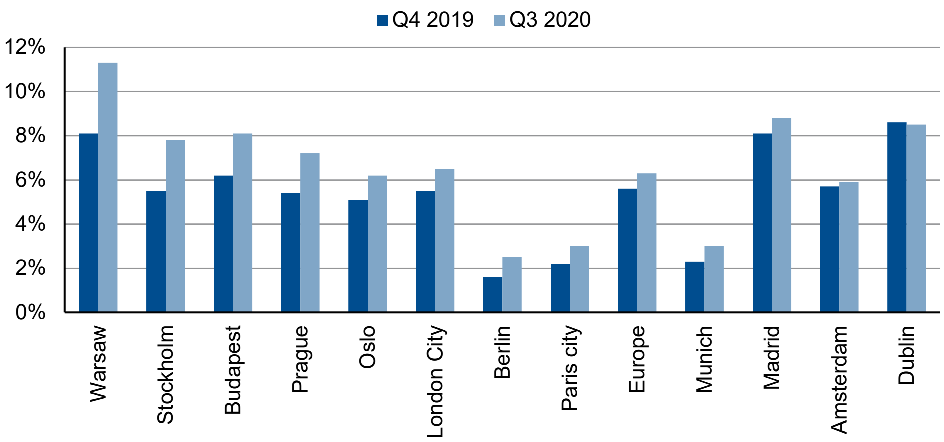
The most important metropoles still showed their resilience, with some core western European markets recording only modest rises in vacancy rates – Paris (+0.8%), Berlin (+0.9%) and Amsterdam (+0.2%) – despite the initial shock of the pandemic. This reflects

[2] Survey by CASS Business School, IESE Business School and HR Service Provider. According to the survey, the European average was about 57% broken down by country as follows: UK (65%) Belgium (62%), Spain (60%), France (59%), the Netherlands (55%) and Germany (40%).
[3] Colliers International "The flexible workspace report 2020 – EMEA". London has the highest supply of Flexible-office providers in Europe (5% of total supply in 2020).

hefty government support for business through furlough programmes and state-backed loans among other meaures.

Other markets however have seen larger increases in the amount of vacant office space, which rose to above 11% in Warsaw (+3.2pp), 8.1% in Budapest (+1.9pp) and to 7.8% in Stockolm (+2.3pp).

Figure 4. Vacant office space in Europe (Q3 2020 vs Q4 2019, %)



Source: Savills Research, Cushman & Wakefield, Scope

Lease duration and development pipeline are important factors

Uncertainty combined with the use of shorter standard leases in some countries partly explain the differences in take-up and vacancy rates across cities. For example, lease terms in the London office market are relatively long -10 years on average- compared to 3-5 years[4] in most continental Europe. This might partly explain London's drastic fall in take-up rates, as some tenants prefer not to commit for such long periods, favoring the flexible-office providers and their offer of short-term leases during such a period of uncertainty. Another factor influencing these variations is the development pipeline, which is more dynamic in central and eastern Europe. This has resulted in newly developed buildings coming on to the market at the same time as landlords put older premises back on the market in response to the recession last year.

Medium-term impact of Covid-19: mixed implications

Favourable and adverse post-pandemic trends

The medium-term, if not permanent, impact of the pandemic on office real estate in Europe remains harder to judge.

Clear shift in working habits

Covid-19 has forced millions to adopt new ways of working. It has also demonstrated that a significant amount of the work previously carried out in offices can be done remotely. This is due in part to recent advances in technology: high-speed internet connections (fixed and wireless), cloud computing, and falling prices for ICT products.

This experiment has resulted in a shift in mindset. Significantly for the long term, some large corporations have adopted remote working as standard practice for at least part of the working week. Examples from Europe and North America include Alphabet Inc.'s Google, Microsoft Inc., Thomson Reuters Corp. and Siemens AG.

Market resilience will be tested when government support ends

The phasing out of pandemic-related government support for business and households will also test the resilience of Europe's office market. Delayed job losses[5] after the Covid-19 shock has passed might impact the demand for office space.

[4] Cushman & Wakefield. "European Coworking Hotspot Index" https://www.cushmanwakefield.com/en/united-kingdom/insights/european-coworking-hotspot-index

[5] According to Eurostat, unemployment has risen in the eurozone and reached 8.3% in December 2020, we estimate that it will peak in 2021 and should reach 9.4%. However, it has not yet reached the level of the previous crisis – when the rate surpassed 12% in 2013.

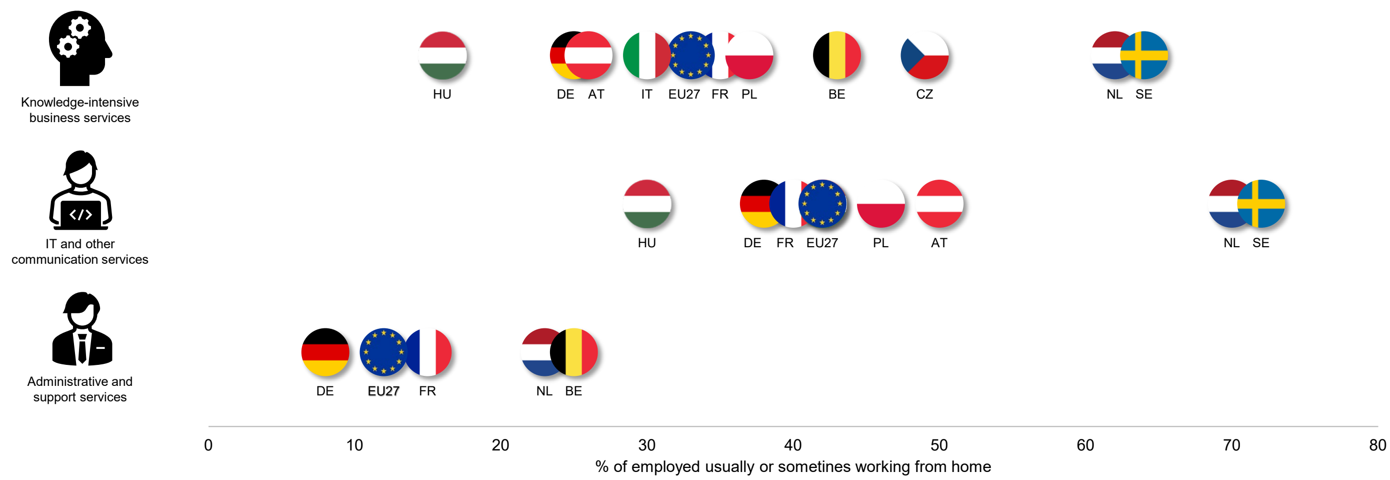
Nordics sustained by previous high prevalence of home office

The longer-term impact of the pandemic in encouraging remote working should be limited in some office markets such as the Nordics, where the practice was already prevalent in the region's metropoles before Covid-19 struck. The impact will be contained as: i) close to 40% of all jobs can be plausibly done from home in the Nordic region, according to a study by the University of Chicago[6] and similar to the remote working levels observed before the pandemic started; ii) Nordic capitals are strongly exposed to the ICT sector, which tends to have higher potential for home working. These sectors already had a relatively high proportion of employees working from home before the Covid-19 crisis (**Figure 5**).

Some other factors, like internet access, legislation and work culture also explain the high prevalence of home office in the Nordic region.

Finland is a good example as a major European tech hub. It is well known as the headquarters of Nokia but is also a successful base for IT firms, gaming start-ups and fintech companies. The country has developed flexible working[7] practices over more than 20 years, rooted in a business culture of mutual trust with a focus on family-friendly work policies and flat rather than hierarchical corporate organisation[8].

Figure 5. Prevalence of remote working in European countries by sector (2018, %)



Source: JRC calculations, Eurostat, Scope

Markets in southern, central, eastern Europe look vulnerable

In contrast, markets where remote working was relatively less prevalent before 2020 - compared with a country's home-working potential - may prove more vulnerable to disruption from the fallout from the pandemic. According to a study of the University of Chicago, at least 30% of jobs can be done from home in countries like Poland and Spain for example. Take-up and rents might suffer in cities with higher pre-pandemic vacancy rates, such as Madrid (9%) or Bucharest (10%), and relatively low levels of home working. Some central and eastern European cities have high vacancy rates – Warsaw 11% and Budapest (8.1%) - and low home-office rates, but also a rich supply pipeline in the coming years. The pipeline in Budapest up to 2024 represents 20.9% of existing office stock; in Warsaw it is 15.5% compared with an average of 6% in Europe.[9]

[6] Dingel J., and Neiman B., "How many jobs can be done at home?" University of Chicago, Booth School of Business. June 2020
[7] https://www.eurofound.europa.eu/observatories/emcc/erm/legislation/finland-working-time-flexibility
[8] According to the global accounting firm Grant Thornton, Finland had the most flexible working schedules what is embedded in its working culture for decades. Already in 2011, 92% of companies allowed workers to adapt their hours, compared to 76% in the UK and the US, 50% in Russia and just 18% in Japan.
[9] AEW Research. https://www.aew.com/research/european-flash-report-covid-19-special-update-4

Home office is not the only variable in the equation

Full or partial home-office working?

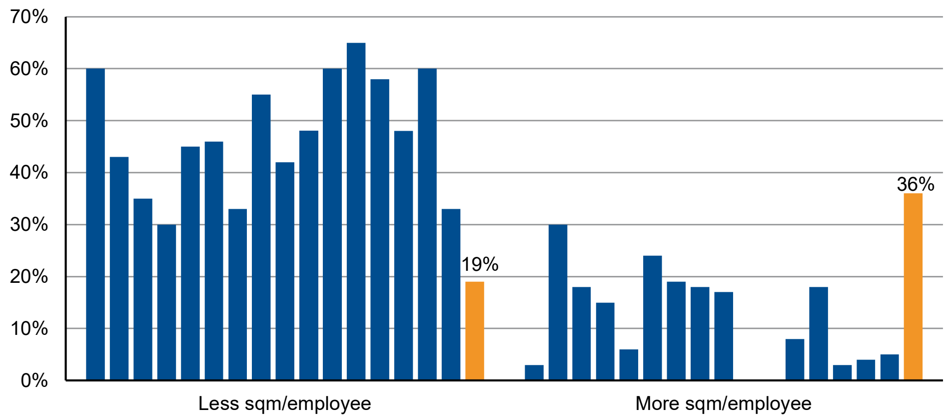
Undeniably, Covid-19 has changed working patterns. If a higher proportion of employees do not need to be in the office at the same time, a reduction in the absolute occupied sqm seems possible. This will particularly be the case if many employees continue to work at home full-time.

However, if the trend is rather for employees to work at home just two to three days a week, there may be little reduction in demand for office space.

Office life will continue

Companies may also have to offer different working conditions to meet new health and safety standards to combat Covid-19. The provision of more space per employee will accelerate a trend toward less dense office occupancy[10] (**Figure 6**). Such a shift would involve creating more meeting rooms, recreational areas and space for collaboration and quiet time, partly as an incentive for employees to return to offices as the authorities relax pandemic protocols.

Figure 6. Oslo: companies planned demand for office area (2020, %)



Source: Survey Akershus Real Estate, Scope

Prestigious addresses will attract tenants

An increase in remote working will at the very least alter how offices are used. Many tenants will reconsider the composition, distribution and specifications of their real estate and office working requirements, hence the impact will also vary across building types.

We believe that demand for modern, high-grade, prestigious and centrally located offices will remain strong, as such buildings are important for corporate branding. However, one question remains: what level of incentives will be necessary to keep occupancy high.

We generally believe Grade-A buildings – also in secondary locations – will benefit from continuous tenant demand, as these buildings could offer a setup in line with new health and safety standards, as well as flexibility to adapt to changing requirements regards surface cuts. Grade-C and outdated buildings independent of their respective locations are vulnerable to tenant-flight and will experience more downward pressure on rents.

Underlying supply-demand balance for office space is tight

Furthermore, we should not underestimate the impact of a robust economic recovery – when pandemic restrictions are more fully lifted – in the context of the tight market conditions for office real estate before Covid-19 struck.

Pandemic might bring demand slightly more in line with supply

In other words, slightly lower demand related to more remote working could bring the office market slightly more into balance rather than significantly increasing the amount of vacant space in Europe's office property market.

[10] Akershus performs a survey among tenants looking for office premises. In previous years, about half of the companies said they were looking for more space, but were reducing sqm/employee. This changed dramatically in 2020, when 36% answered that they planned to let an office with more sqm/employee.

Credit implications

Markets with high pre-pandemic remote working look resilient

The increase in the amount of remote working – boosted by Covid-19 - is going to test the portfolio strength of Europe’s real estate companies. Companies with portfolios located in countries with high pre-pandemic levels of home working and low vacancies, such as the Nordics or the Netherlands, look particularly resilient. Demand in other markets will be more challenged and the composition of each company’s property portfolio remains a critical factor.

Companies with top-tier portfolios face little extra risk

The credit risk profile of firms will remain strong if their portfolios comprise resilient assets with secure rental cashflow:

- High-quality modern premises, supporting a company’s brand, in core CBD locations
- Grade-A and Grade-B buildings if they offer modern flexible space able to accommodate future occupier requirements
- Locations in markets with high previous exposure to remote working
- Leased to a strong and solvent tenant-mix, and/or exposed to government agencies - typically “sticky” tenants
- Leased on a long-term basis or showing a high-tenant retention rate
- Well-connected gateway office offering less commute timing for employees

Favourable demand-supply balance for Grade-A assets

With demand strong and new supply of top-tier assets limited, we do not expect a significant adjustment in rents or cap rates in the short to medium term.

The resilience of portfolios located in secondary locations will also very much depend on the building characteristics, but building owners might experience more pressure, especially when if they do not have the flexibility to accommodate the expected shift in demand. If offices are located in markets not previously exposed to a high degree of remote working, increasing vacancies might jeopardize the asset valuations, as tenants will assess their long-term needs for office space with these structural changes in mind.

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
23 Boulevard des Capucines
F-75002 Paris

Phone +33 1 8288 5557

Oslo
Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

Madrid
Edificio Torre Europa
Paseo de la Castellana 95
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

111 Buckingham Palace Road
London SW1W 0SR

Phone +44020-7340-6347

info@scoperatings.com
www.scoperatings.com