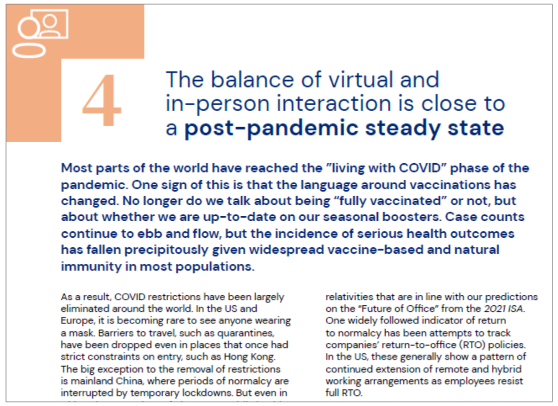
ISA by LaSalle | Insights Strategy Analysis

Focus

Revisiting the future of office

March 2023

Time to check in on global office markets


4 The balance of virtual and in-person interaction is close to a **post-pandemic steady state**

Most parts of the world have reached the "living with COVID" phase of the pandemic. One sign of this is that the language around vaccinations has changed. No longer do we talk about being "fully vaccinated" or not, but about whether we are up-to-date on our seasonal boosters. Case counts continue to ebb and flow, but the incidence of serious health outcomes has fallen precipitously given widespread vaccine-based and natural immunity in most populations.

As a result, COVID restrictions have been largely eliminated around the world. In the US and Europe, it is becoming rare to see anyone wearing a mask. Barriers to travel, such as quarantines, have been dropped even in places that once had strict constraints on entry, such as Hong Kong. The big exception to the removal of restrictions is mainland China, where periods of normalcy are interrupted by temporary lockdowns. But even in

relativities that are in line with our predictions on the "Future of Office" from the *2021 ISA*. One widely followed indicator of return to normalcy has been attempts to track companies' return-to-office (RTO) policies. In the US, these generally show a pattern of continued extension of remote and hybrid working arrangements as employees resist full RTO.

ISA Outlook 2023 global theme 4

Why now?

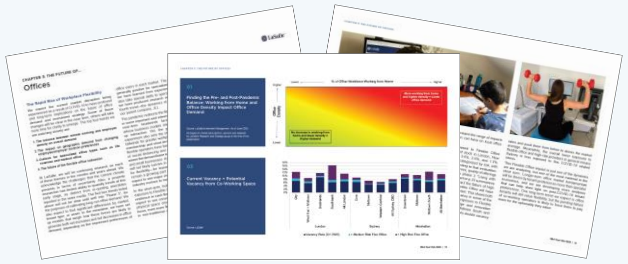
The balance of virtual and in-person interaction is close to a post-pandemic steady state. So we observed in our ISA Outlook 2023, where we called this out as one of our key global themes for the year. We pointed out that after a long period of gradual improvement in office attendance, the rate of change has substantially leveled off, with weekly office visits stabilizing below 50% in many US markets, and at somewhat higher levels in Europe and substantially higher levels in much of Asia-Pacific.

In many markets, but especially North America, work-from-home (WFH) headwinds have hit leasing demand as leases roll. An anticipated boost from permanent social distancing failed to materialize. At the same time, the cyclical outlook for job growth has weakened with the macroeconomy. These factors have contributed to deepening worries about the prospects for office values, which have made front-page news due to prominent defaults on commercial mortgages backed by office assets.

In this context, we thought it important to revisit the prospects for the office sector, addressing key questions, while highlighting differences and similarities among global markets. Where are risks greatest and where are they less? How should we think about the role of office in the portfolio? How will current trends play out in the various regions where we invest?

This is also an opportunity to look back on our predictions to assess where we got things right, and where we did not. As a part of this, we introduce a new feature in our ISA suite, **"Looking Back"**, in which we check on our prior predictions and forecasts.

LOOKING BACK


"The future of offices", *Mid-Year ISA 2020*

- In the Mid-Year ISA 2020, our first global report during the pandemic, we concluded that the demand for flexibility in office space—for leases and space layouts—would represent a growing part of the market. However, we predicted significant changes in how the office industry would evolve to meet this demand, which would take considerable time to play out.
- In our ISA 2021, we laid out a comprehensive global view on the future of office markets. A key element of this was our assessment of risk on various metrics like return-to-office (RTO) propensities and fundamentals. Our assessment put US gateway CBDs most at risk, Japan and China the least at risk, with Europe in the middle. These relativities are consistent with how trends have played out, and how we see office markets today. (An updated version of our assessment table is included on page 14 of this report.)
- We predicted that tenant location preferences would be essentially unchanged from pre-pandemic, with no emergence of a satellite model. Given the purpose of the office is to facilitate in-person collaboration, we projected that centralized offices would remain relevant, even if used less than before. On that basis, we also correctly predicted a clustering of office usage on peak days, rather than a distributed use pattern throughout the week that would have been worse for space demand.


"The future of office properties", *Investment Strategy Annual 2021*

- We rightly predicted that the best quality office buildings would outperform, though we were focused on features like touchless controls rather than sustainability credentials and "sense of place" that have emerged as the key differentiators.

Current LaSalle views on the future of office

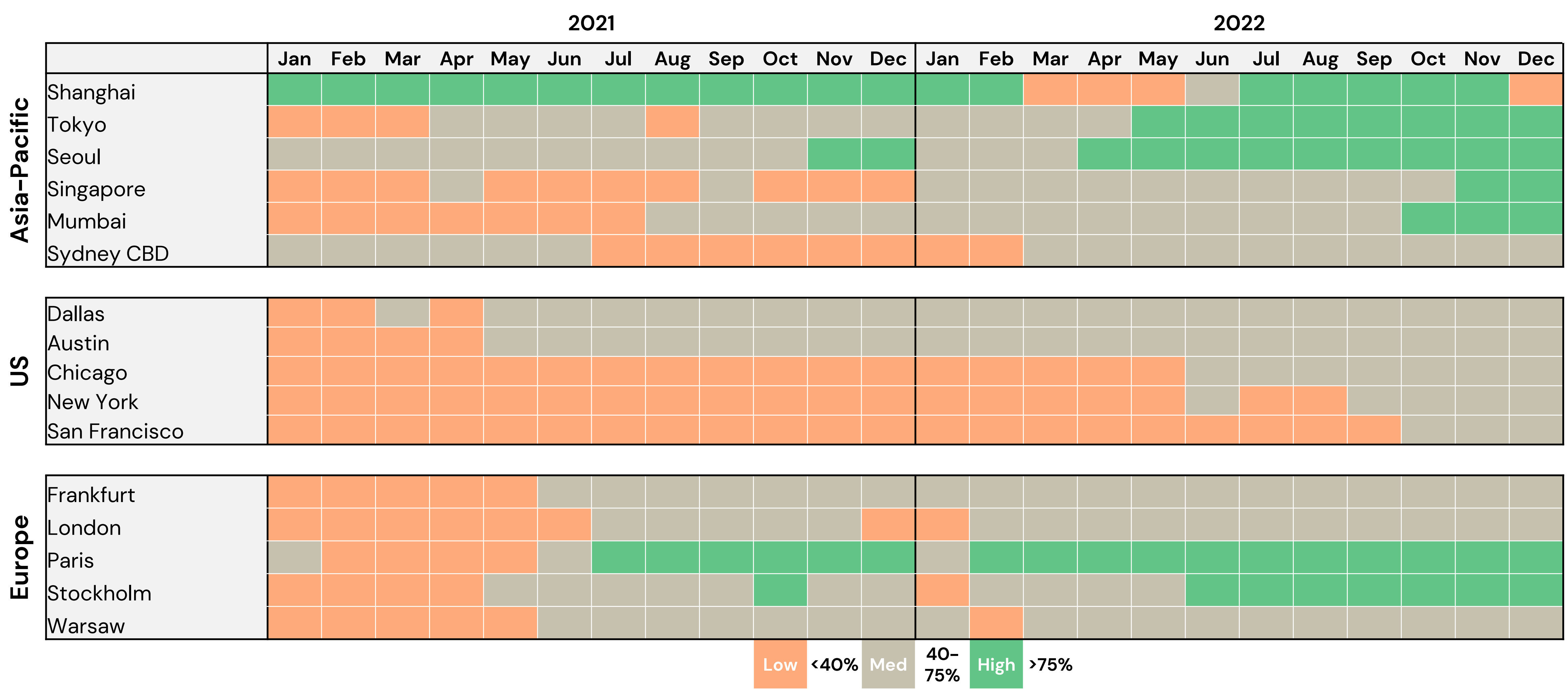
- **Office demand risk and investor perception of office risk relative to other sectors have increased but vary globally.** Investors should be compensated for higher risk with higher returns than in lower-risk property sectors.
- **RTO trends and occupancy rates vary globally, with Asia-Pacific leading and the US lagging.** Changes to office usage will be phased in. This will lead to a slower recovery as firms re-size spaces for new workspace strategies.
- **Office experience and amenities remain critical.** As hybrid working becomes the norm, the accessibility, flexibility, technology infrastructure and amenity offering of the office are key to facilitate attendance, talent attraction/retention, in-office collaboration and overall tenant demand.
- **Office will remain a bifurcated sector, with older buildings at risk of becoming stranded assets.** There will be increasing divergence in performance between high-quality assets and older buildings, which will require major capital investment to meet changing tenant requirements and regulations.
- **ESG/net zero carbon (NZC) tenant demand and regulations** are having a material impact, with European office markets leading the way. Other regions are not yet seeing the same level of focus on these factors, but they are expected to follow the same path.
- **An allocation to office remains an important part of a diversified portfolio,** but its share of allocations and investment activity is falling in favor of other sectors.
- **Capital markets activity in the office sector is falling globally.** Capital flowing into offices is below the 3-year average in most global markets and bid-ask spreads have increased.

Note: Based on the views and opinions of LaSalle Investment Management Research and Strategy

Return to office: Asia-Pacific leading the way

Variation in office attendance both between and within regions

Estimate of office visits as % of pre-pandemic level

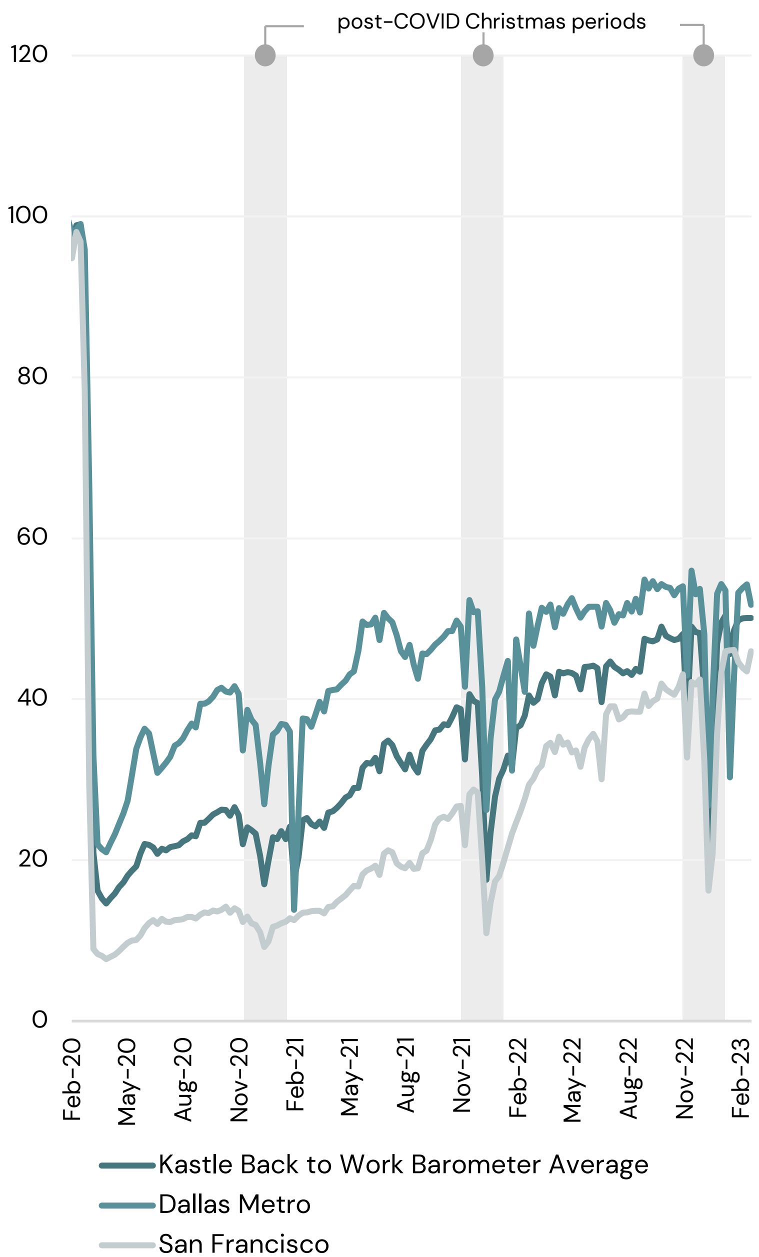


Consistent data comparing real-time building occupancy rates across regions are hard to come by, but clearer signals are emerging. The table above is based on JLL estimates and reinforces the trends indicated from various local sources—that physical occupancy rates are highest in Asia-Pacific, followed by Europe, with the US lagging, although there are also variations within regions. Within Asia-Pacific, Tokyo, Singapore and Seoul show higher physical occupancy rates than Sydney, while within Europe, Paris and Stockholm are ahead of London and Frankfurt. Within the US, the trend of a slower return to office is more consistent across cities.

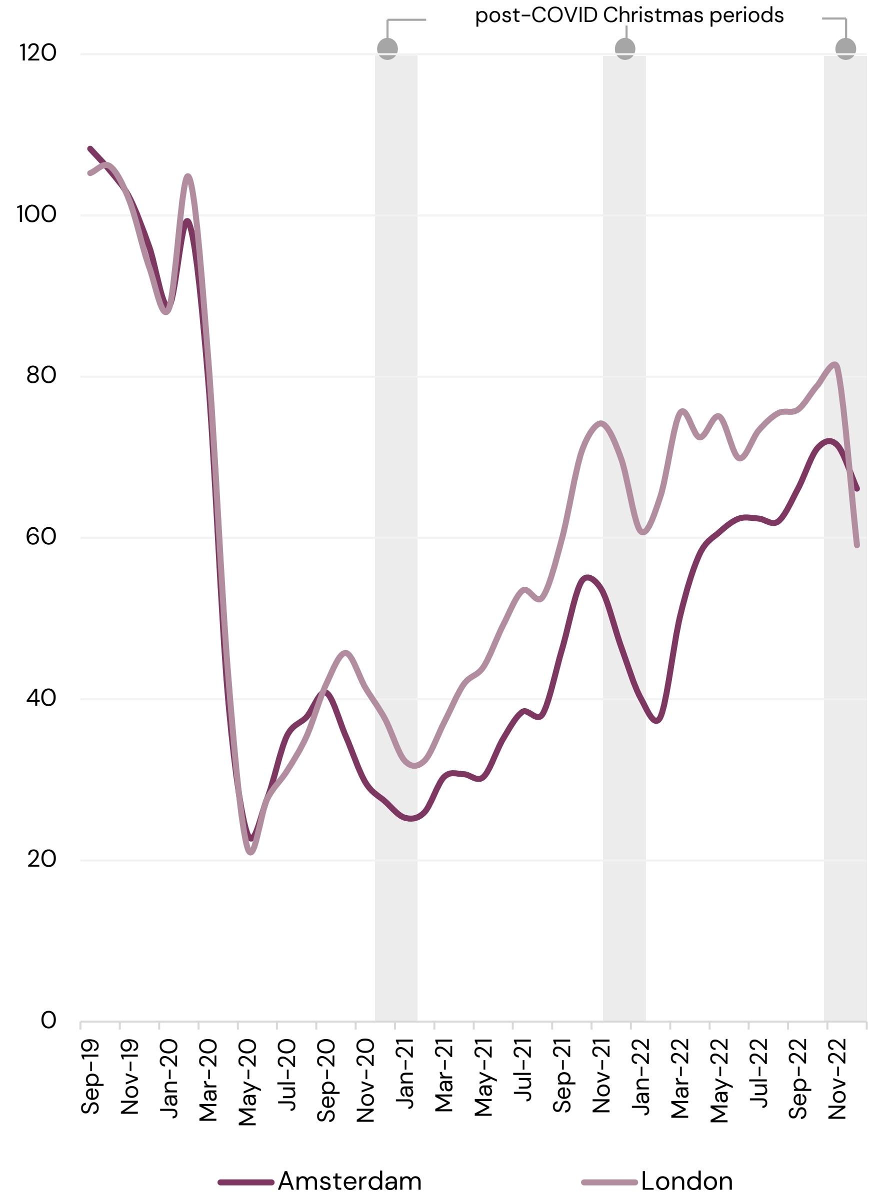
Source: JLL (12/22). Note: Past performance is not indicative of future results. There is no guarantee that any trends shown herein will continue or that any forecasts shown herein will materialize as expected.

Proxies for physical occupancy show nuance

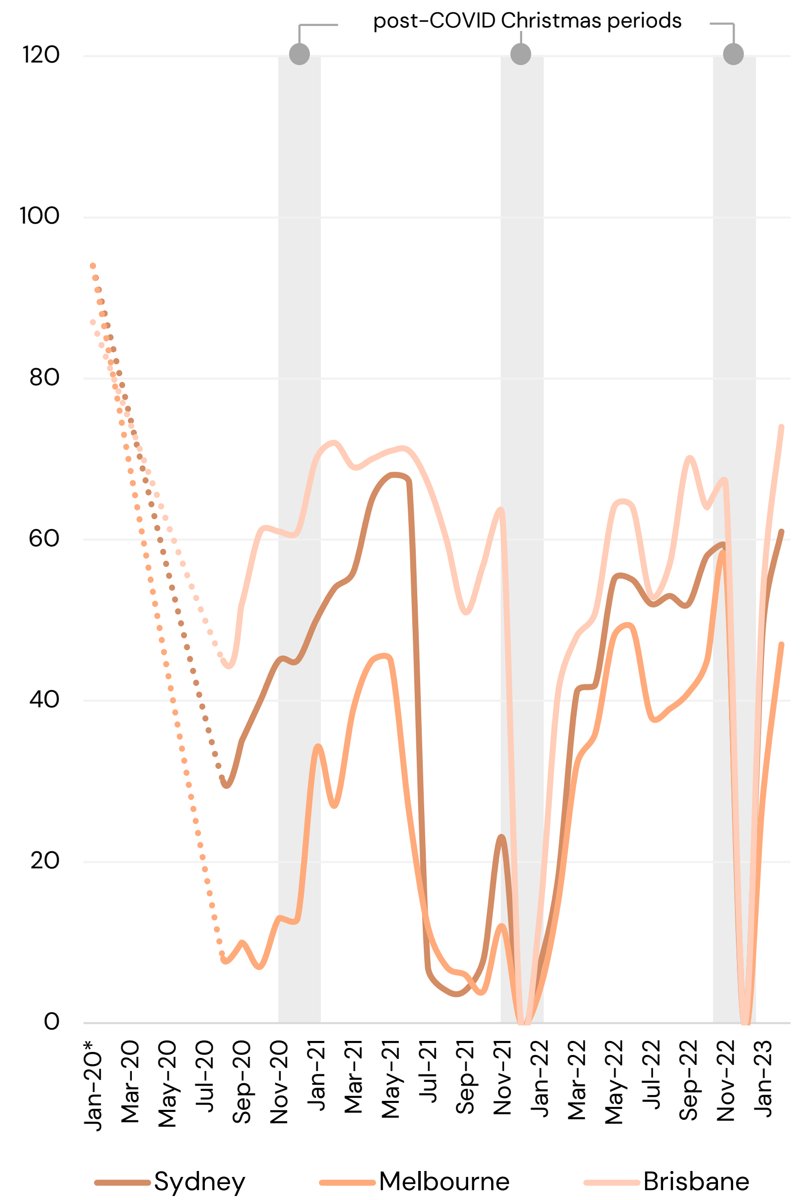
US: Key card entries
[% relative to pre-COVID baseline]



Europe: Office elevator trips by city
[% relative to pre-COVID baseline]



Australia: CBD office physical occupancy rate
[survey of physical occupancy, %]



Proxies for physical occupancy, such as keycard entries and elevator usage, provide a higher frequency look at occupancy, but are not available for all markets. They generally corroborate the JLL data on the prior page, although it's worth noting that Australia is the lower bound of the Asia-Pacific range, with Singapore, Hong Kong and Japan all higher.

Note: Kastle's US data based on weekly key card entries into office buildings, Kone's data for Europe uses office elevator trips as a proxy for physical occupancy, Australian figures are based on responses from PCA members who own or manage CBD office buildings and cover occupancy metrics.
Source: Kastle Systems (22/2/2023), Property Council of Australia (02/23), Kone (01/23) data as at 7th March 2023.
There is no guarantee that any trends shown herein will continue or that any forecasts shown herein will materialize as expected.

How we think about the impact of work-from-home

WFH impact varies by region based on culture, housing and transport

Why do rates of WFH/RTO vary so much across the world?

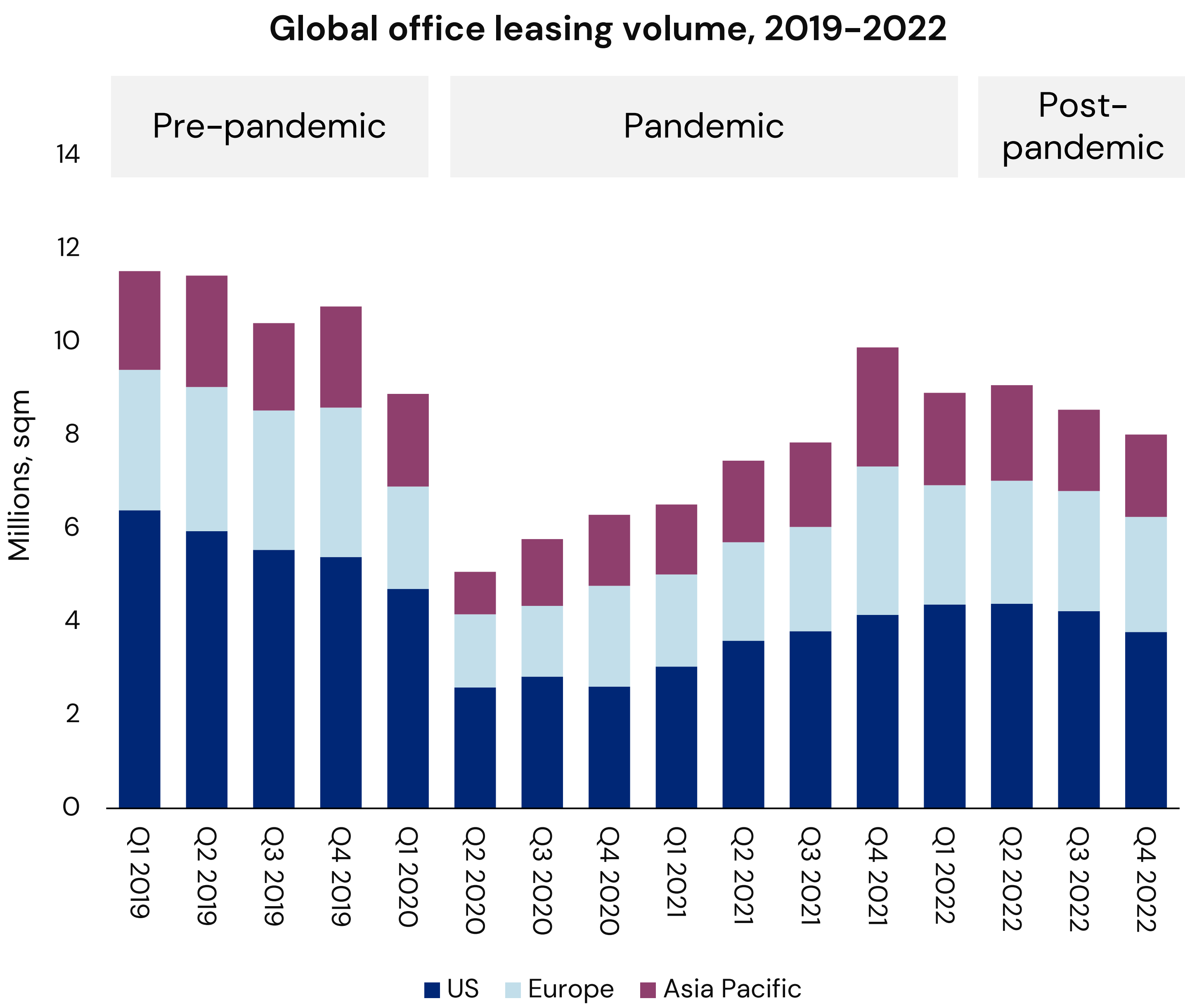
- **The propensity to work from home is dependent on various factors.** These include commute time/cost, job role, the culture of the respective market or sector, dwelling size and workspace as well as the age profile of employees. All else equal, shorter commutes, smaller dwellings, a "face time" culture and younger employees in higher value-add collaborative roles point to higher RTO. In reality, a market has a mix of counterbalancing factors, so it is difficult to pinpoint exactly why a particular city has a certain level of RTO.
- **City-level variation is partly a function of total accumulated days with COVID restrictions** in place during the pandemic, with cities with longer lockdowns having given workers and firms more time to change their habits. For example, office attendance in Dallas is ahead of San Francisco, while Brisbane is ahead of Melbourne.

What does this mean for office demand?

- **Office space needs are driven by peak demand loads, not the average capacity.** Occupancy tends to be higher on Tuesday, Wednesday and Thursday, with Fridays the quietest. Office attendance that is less frequent but concentrated on specific days reinforces the role of offices as hubs of in-person collaboration and means that companies will need to re-imagine their existing spaces to get the best out of their office-based and hybrid-working employees
- **Impacts will be at the margin.** Office demand does not have to "collapse" for an adverse effect on demand, rents, and values. If some workers move to full-time WFH, space requirements can be reduced. However, even a 5-10% decline in demand could create an elevated vacancy for an extended period. The impact of such a decline is not uniform, and it can vary by location, property quality, and other factors.
- **Timing matters.** Structural headwinds have an extended impact rather than a sizeable short-term impact in markets with longer lease terms. This interacts with the cyclical demand decline and eventual economic rebound. These interacting time dynamics affect total office space demand, market rents, and asset cash flow.
- **Location and office quality**: Office demand is expected to further bifurcate by location and office quality due to changing tenant requirements and work styles. As a result, a wider dispersion in investment performance is expected, even for assets within the same submarket. Investors need to understand the location, office quality, and micro-locations to drive strong investment performance in the office sector.

Leasing demand recovered

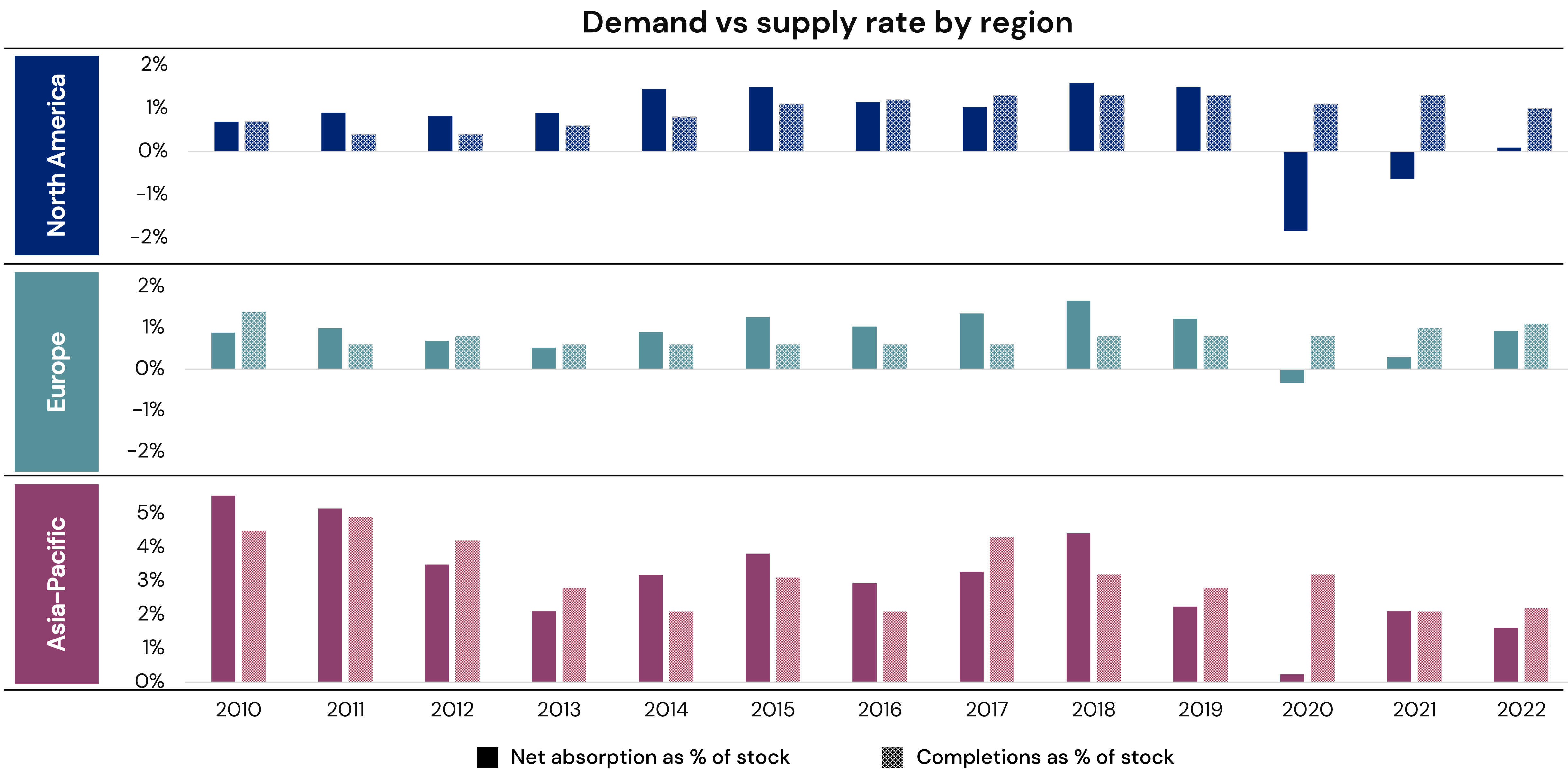
Yet remains below pre-pandemic levels in all regions



- While leasing demand has recovered since the onset of the pandemic, the trailing 4-quarter leasing volume in Q4 2022 was below pre-pandemic levels (quarterly Q1 2019-Q1 2020 average) in all regions.
- The reduction compared to pre-pandemic levels is more pronounced in the US where levels are 25% lower (-12% and -11% in Europe and Asia-Pacific).

Source: JLL, CBRE, Q4 2022.
Note: Past performance is not indicative of future results. There is no guarantee that any trends shown herein will continue or that any forecasts shown herein will materialize as expected.

Demand is trailing long-term average as well as new supply, but has fared better in Europe and Asia-Pacific



- During the pandemic, the North American office market saw negative net absorption of 10.1M sqm (2.4% of stock), whereas Europe only saw a decline in occupied space of 880k sqm (0.3% of stock). Net absorption in Asia-Pacific in 2020 was positive, but soft, at only 0.2% of stock.
- Globally, office fundamentals have remained weak since the pandemic, with net absorption in North America underperforming Europe and Asia-Pacific. North America continues to struggle with consolidation and release of secondhand space. An increase in construction and financing costs will likely moderate new development globally going forward.

Note:: Asia-Pacific aggregate includes all grades offices in Australia CBDs, Greater China (i.e., Beijing, Shanghai and Hong Kong), Tokyo 23 wards, Osaka, Singapore CBD, and Seoul. North America includes US and Canada office markets.
Source: PMA (12/22), CBRE-EA (Q4 22), CBRE (Q4 22), JLL REIS (Q4 22), LaSalle (03/23).
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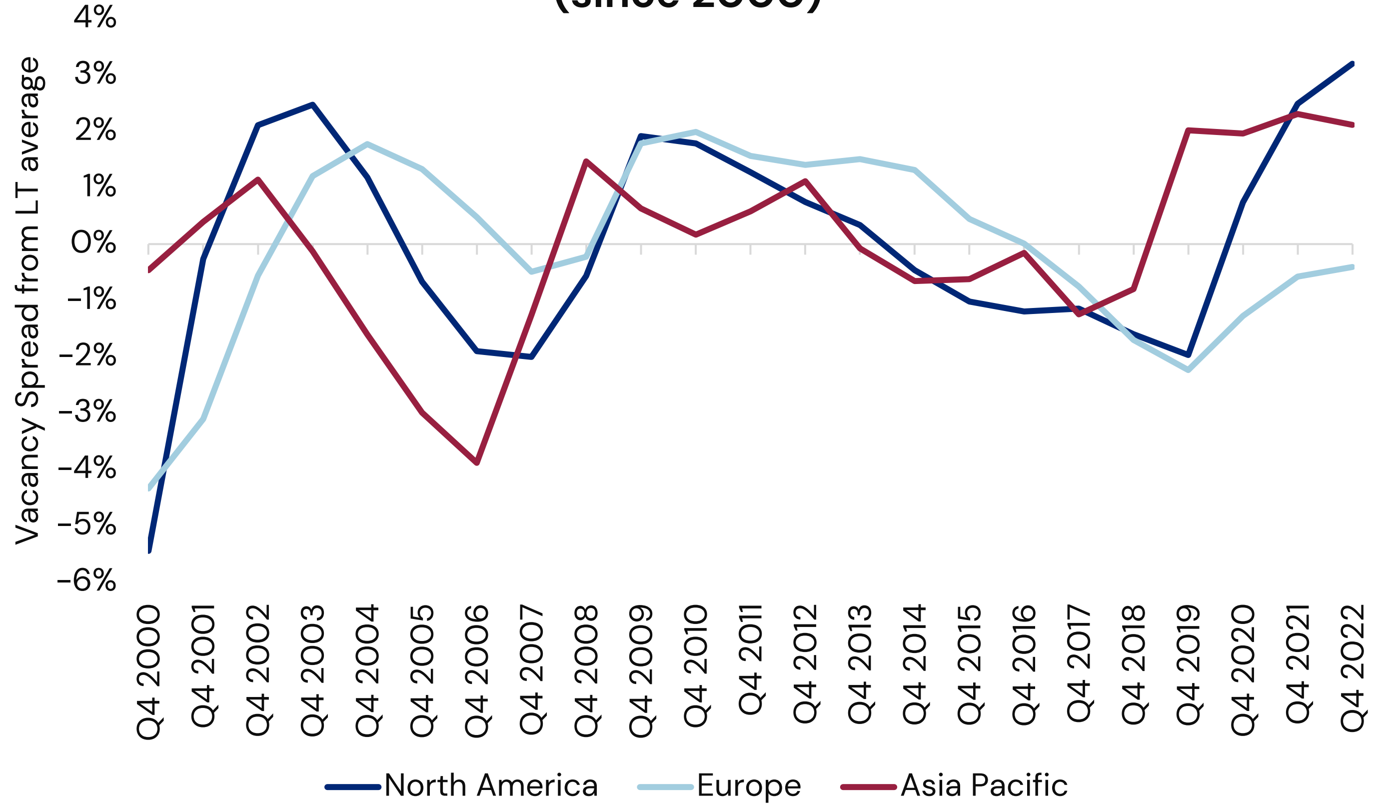
North America vacancy above long-term average, Europe slightly below



- The vacancy rate trend in all regions had been similar pre-pandemic but has since diverged.
- Currently, North America's vacancy rate of 17.2% is 3.2 percentage points above its long-term average, and Asia-Pacific's 9.4% is 2.1% above; however, Europe's rate of 7.1% is 0.4% below its long-term average.
- Asia-Pacific's relatively high current vacancy rate is driven by office submarkets in Australia and Greater China.
- Demolitions and conversions alongside recovering demand have kept the increase in European vacancy under control despite recently elevated completions.

Note. North America includes US and Canada office markets Source: CBRE-EA (Q4 22), CBRE (Q4 22), JLL (Q4 22), JLL REIS (Q4 22),, LaSalle (03/23).
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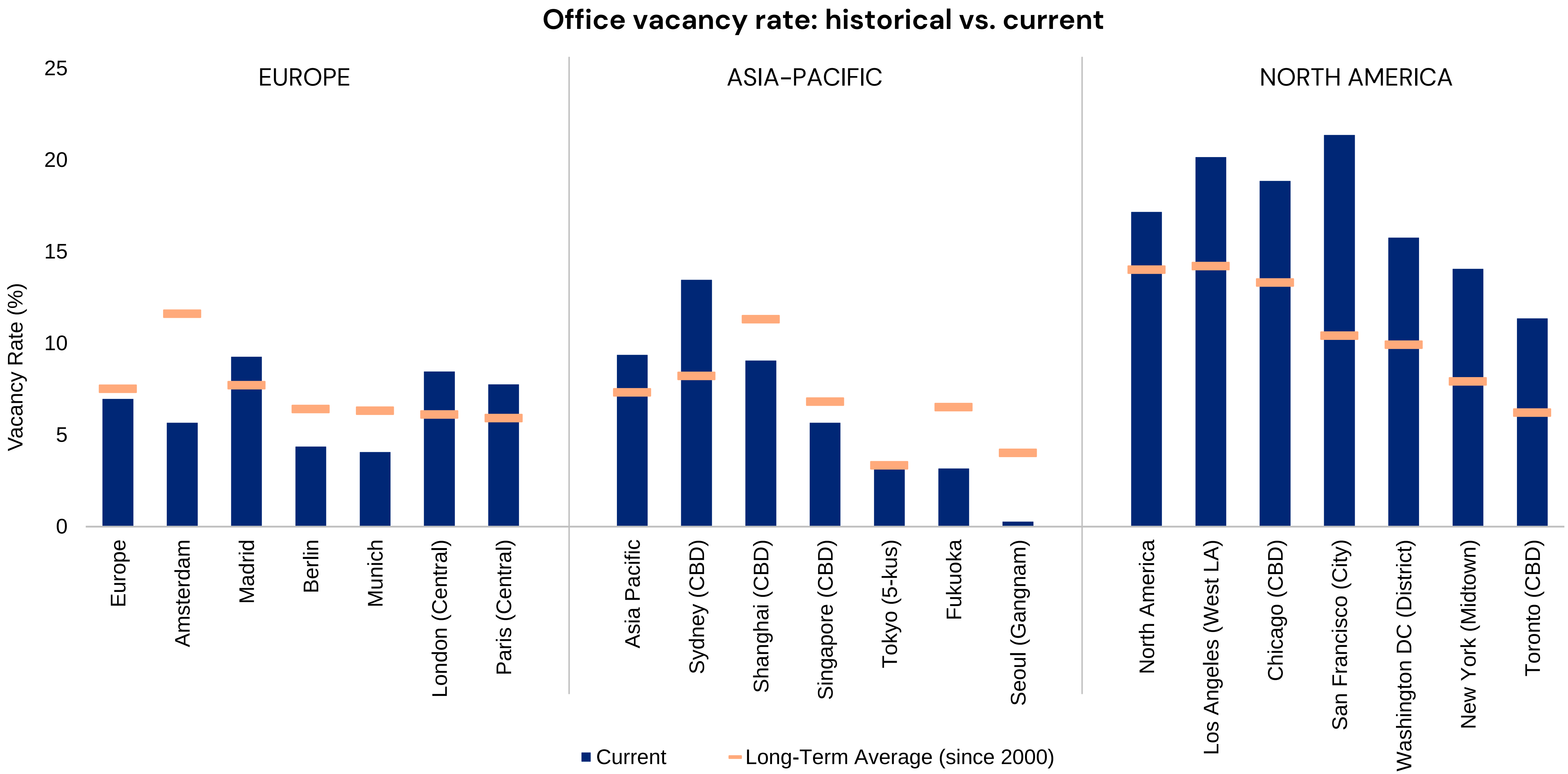
Secular drivers and supply differentiate city-level prospects



- Office vacancy rates in Europe and Asia-Pacific remain close to or below long-term averages in most markets (with exception of Sydney), in stark contrast to North America where vacancy rates are much higher and above long-term averages in all cases.
- Vacancy rates in markets such as Seoul and Singapore have been lower than long-term averages due to fewer new completions and high return-to-office ratios. In Sydney, high-quality offices in well-located areas continue to perform well, despite market vacancy rates being above long-term averages.

Note. North America includes US and Canada office markets
Source: CBRE-EA, CBRE, JLL REIS, JLL (01/23). Data as of Q4 2022. Note – the time period used for the long-term average differs between markets based on data availability and market maturity
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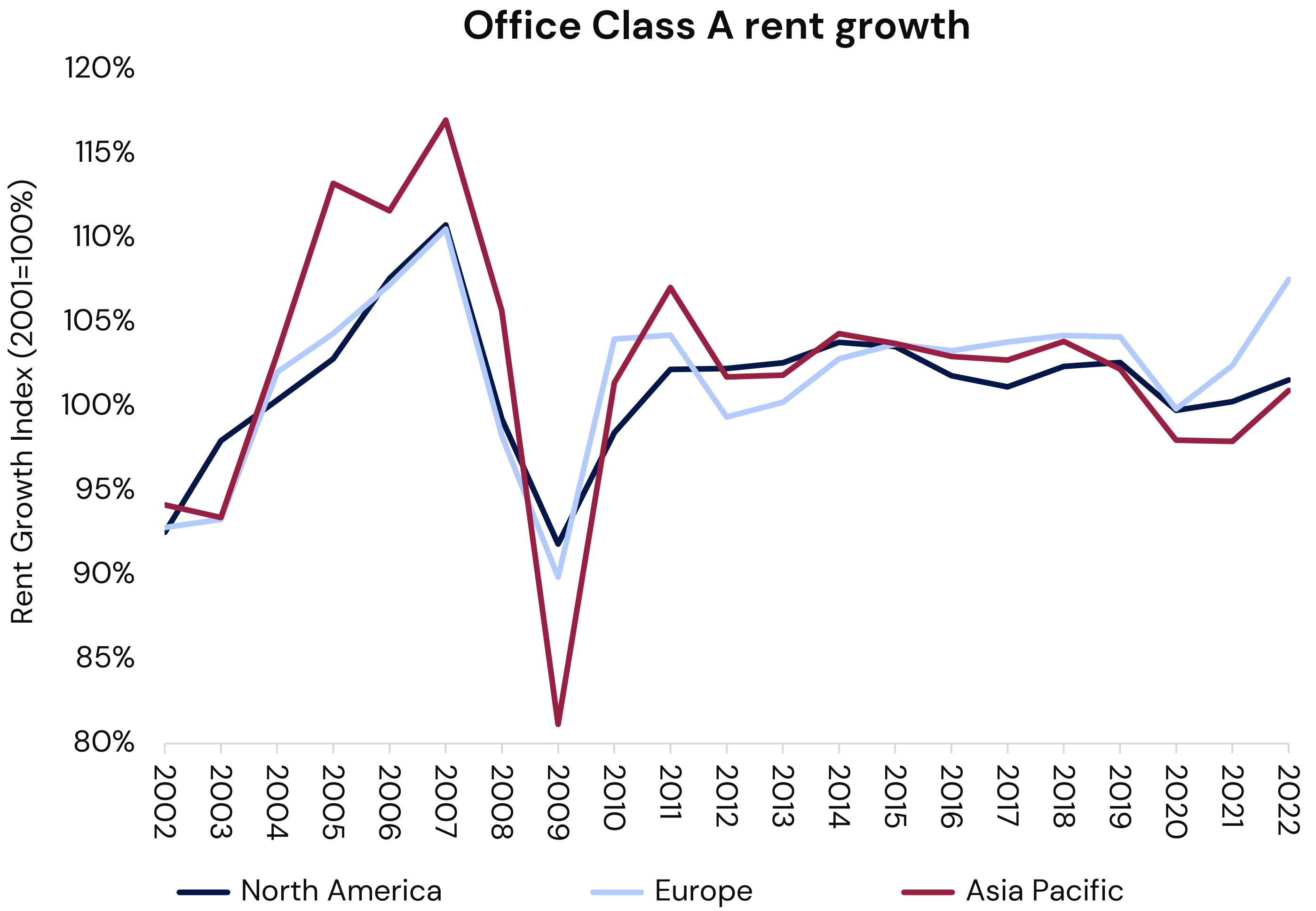
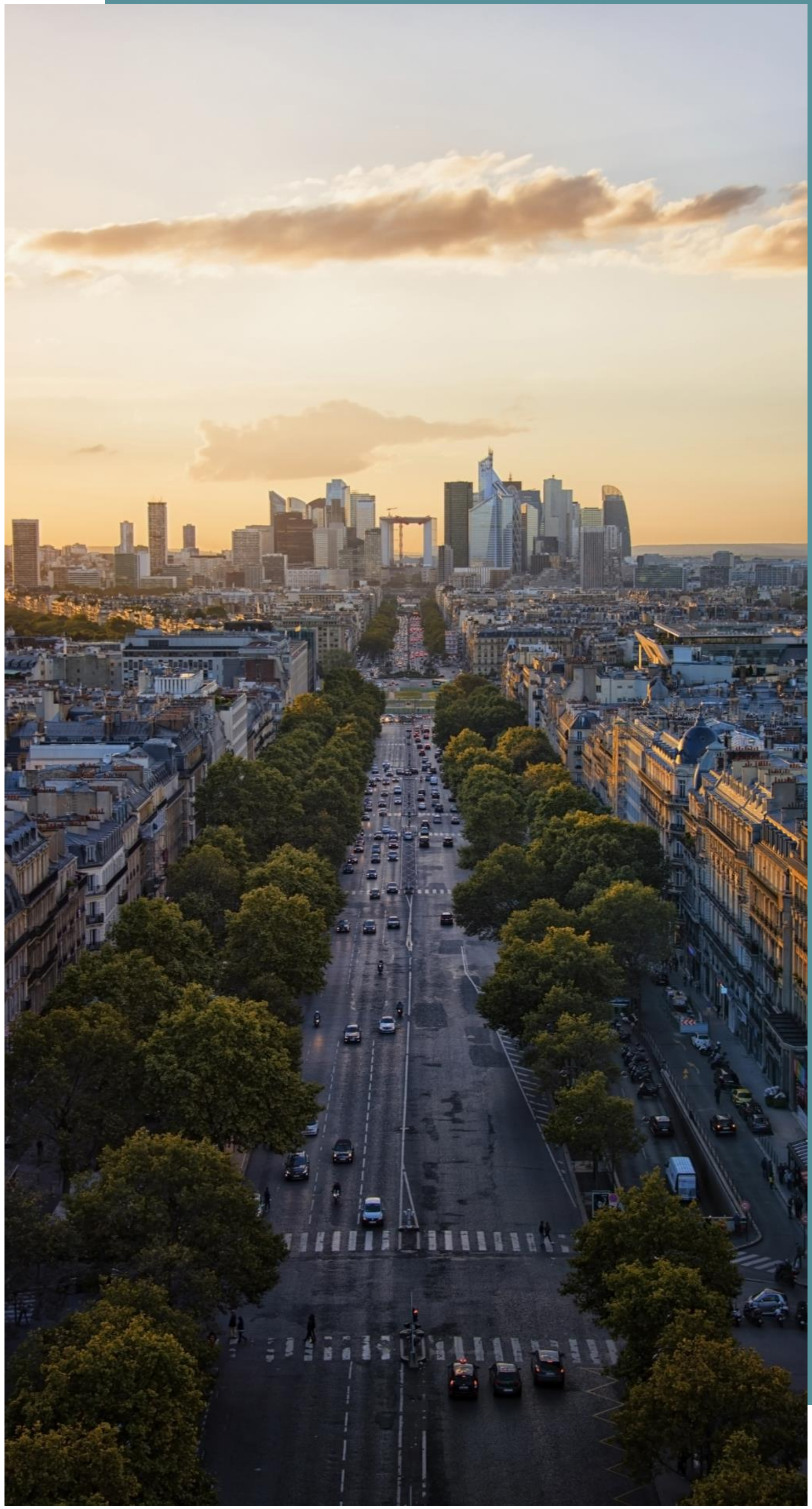
Rent data for Class A hides quality divides



- Asia-Pacific's 2.5% 20-year average rent growth is 70-130bps above Europe's and North America's, yet Asia-Pacific's growth has been volatile ranging from +17% in 2007 and -18.9% in 2009.
- Office rent growth is challenging to measure consistently given the wide range in reported rent changes. In North America specifically, average effective rents declined more during the pandemic as compared to Class A asking rents shown above. Europe data are for prime headline rents*, which hides divides between quality as well as the level of incentives offered.

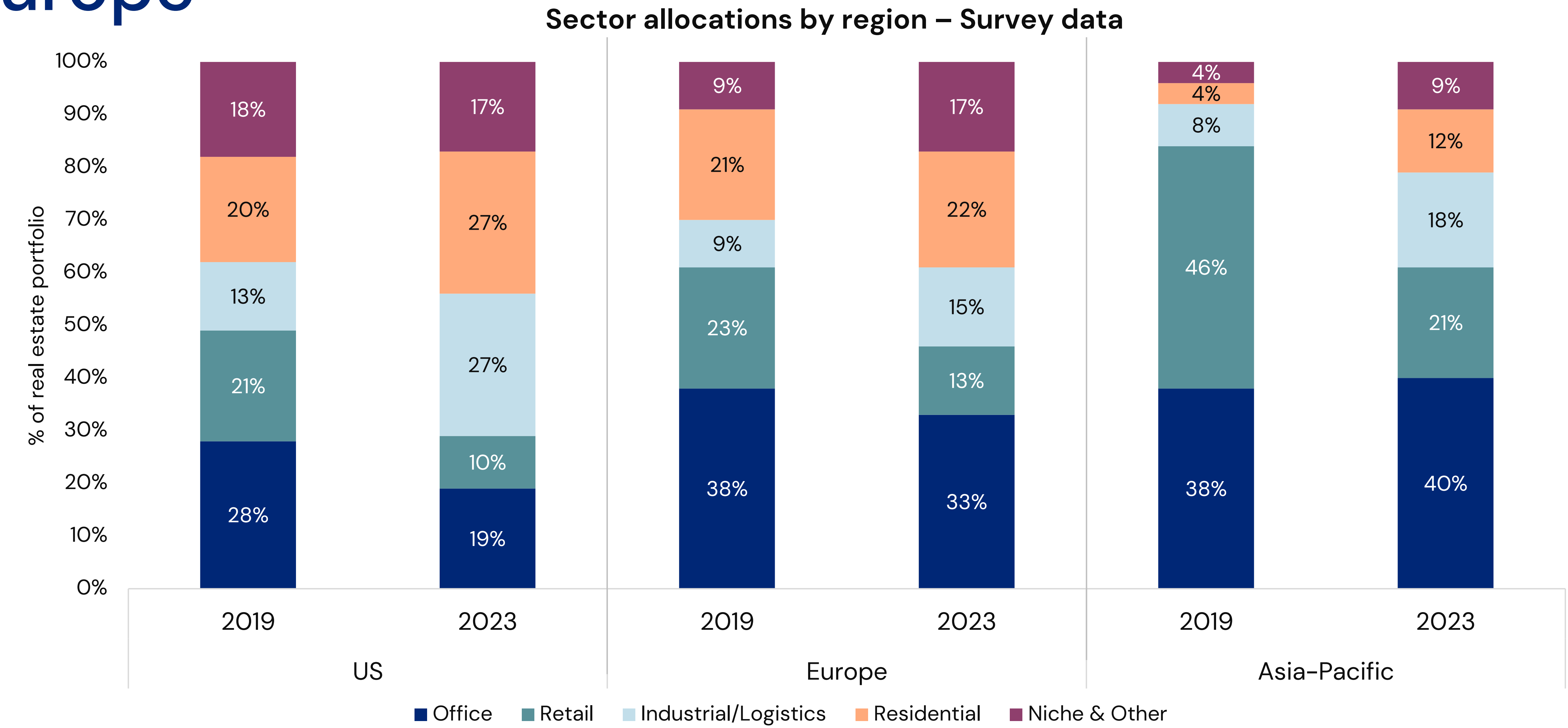


Source: CBRE-EA, CBRE, JLL REIS, JLL (01/23). Data as of Q4 2022. Note - the time period used for the long-term average differs between markets based on data availability and market maturate. Asia-Pacific aggregate includes all grades offices in Australia CBDs, Greater China (i.e., Beijing, Shanghai and Hong Kong Central), Tokyo 23 wards, Osaka, Singapore CBD, and Seoul. North America includes US and Canada office markets

*the top open-market rent that could be expected for a notional office unit of the highest quality and specification in the best location in a market.

Past performance is not necessarily indicative of future results. There is no guarantee that any trends shown herein will continue

Office remains important globally, but its share of activity & portfolios falling in North America and Europe



Data comparing sector allocations of portfolios globally require caveats. Index allocations are not a reliable guide, given varying degrees of coverage by index providers between regions. Above we use survey data from the PREA/INREV/ANREV Investor Intentions Survey. These will be sensitive to changes in the sample, which likely explain some of the exaggerated swings such as the sharp reduction in the retail Asia-Pacific allocation between 2019 and 2023.

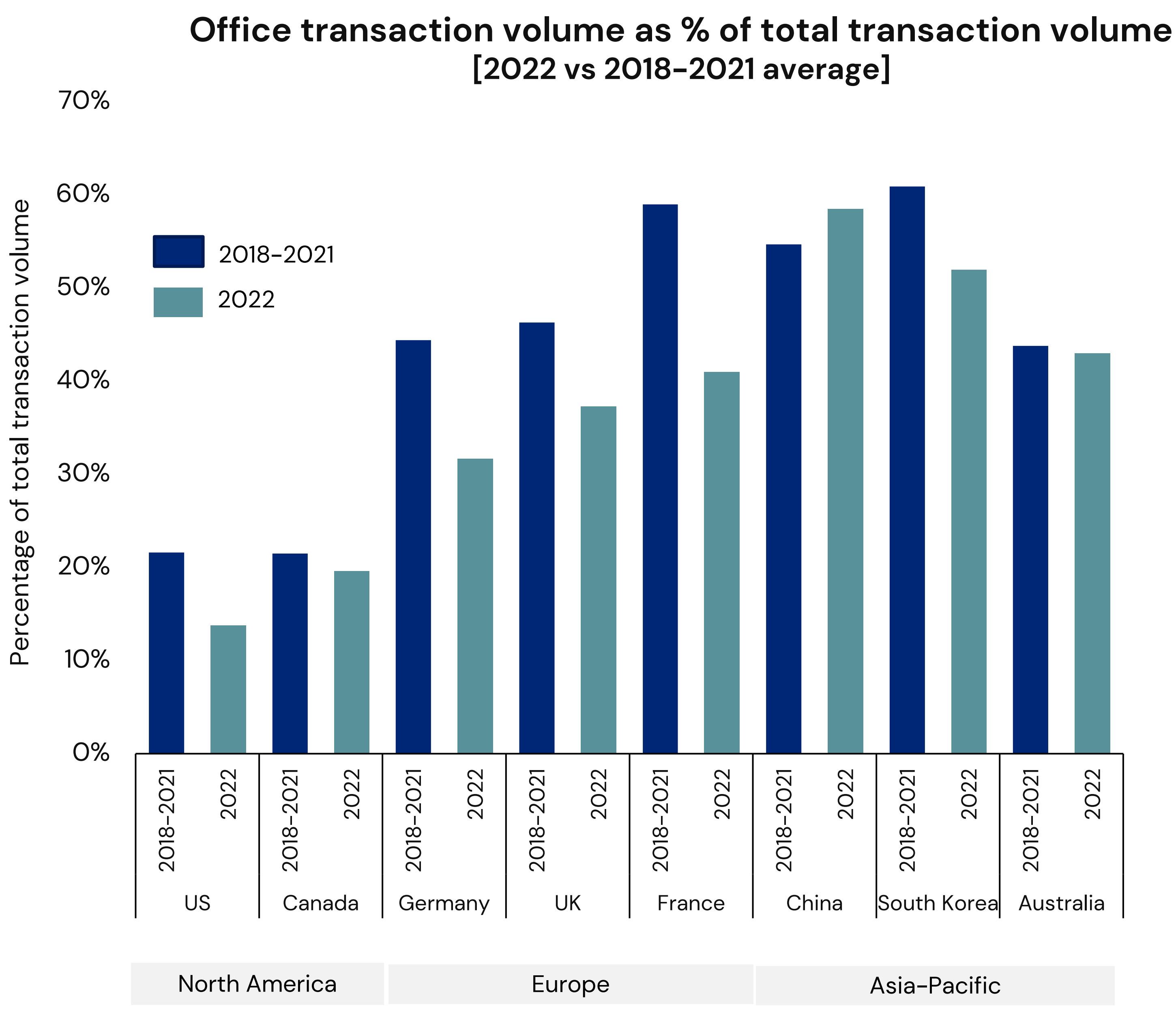
Office remains a larger share of portfolios in Europe and Asia-Pacific than in North America. This lower allocation means that the office sector's weaker prospects in North America will have a lesser impact on overall market returns than it would otherwise have. While we expect continued diversification into new sectors globally, office is likely to remain a key part of European and Asia-Pacific portfolios for the foreseeable future.

Source: PREA Investor Intentions Survey, 2019 & 2023.

Past performance is not indicative of future results. There is no guarantee that any trends shown herein will continue or that any forecasts shown herein will materialize as expected.

Office capital flows decline

Capital flowing into offices below 3-year average in most global markets and bid-ask spreads increase

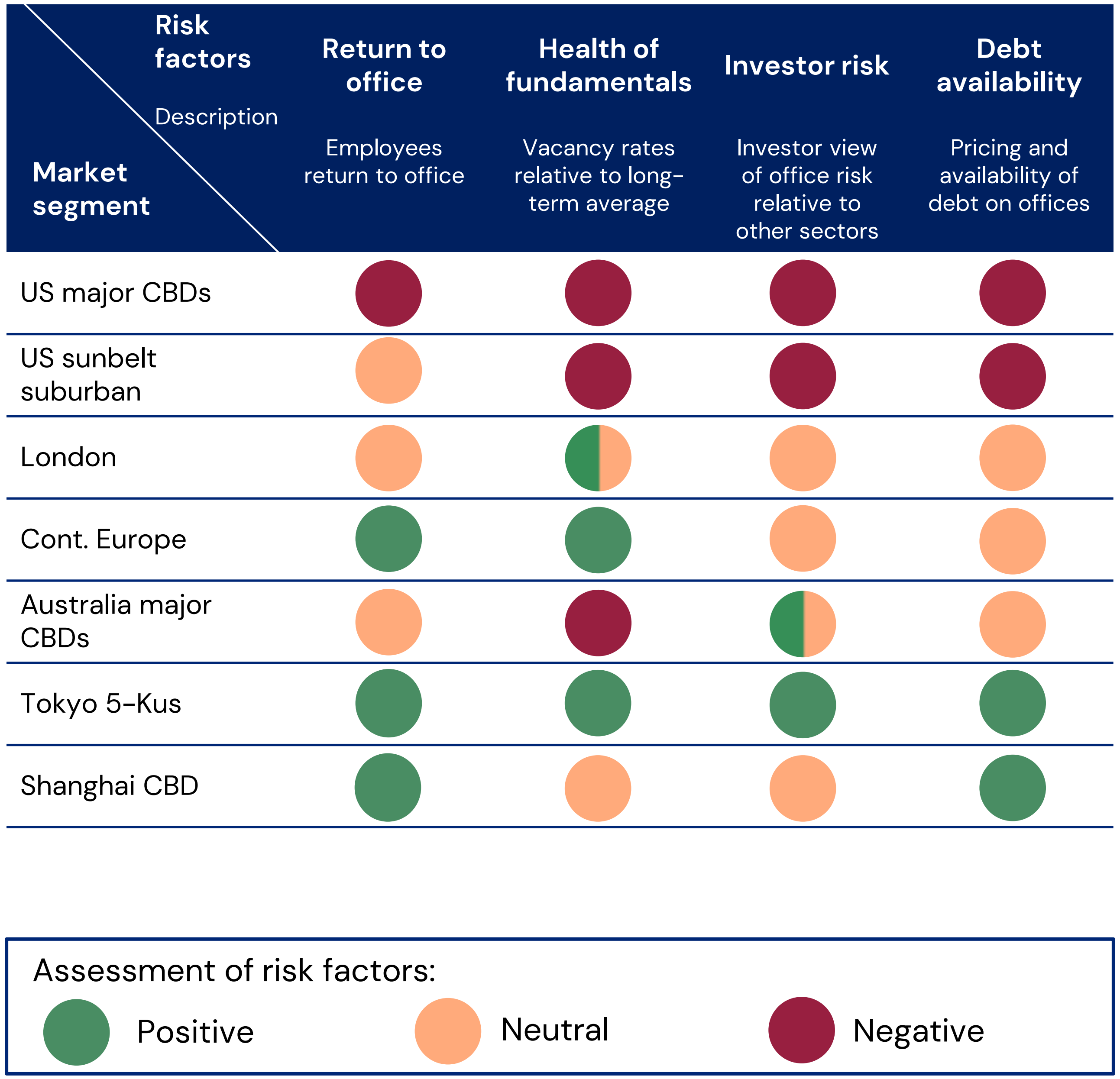


- **Office investment as a share of total transaction volume has declined** by approximately 20% in North America, versus 50% in Europe and Asia-Pacific, between 2018 and 2021.
- **Price discovery challenges affected all regions/markets as the bid-ask spread widened** in 2022. The exception was China, where outlier policies support growth and RTO has been strong, barring lockdowns which have now ended.
- **Real world outcomes are more bifurcated than implied by the data,** as office investments are focused on high-quality assets, and uncertainties remain in Class B and value-add assets.

Source: JLL (02/23). Data as of Q4 2022.
Past performance is not necessarily indicative of future results. There is no guarantee that any trends shown herein will continue

Office risk factors comparison

Office situation on a variety of metrics is better in Europe and Asia-Pacific



- **Return to office** in the US is lagging Europe and Asia-Pacific which has the highest physical occupancy rates post pandemic. Factors at play in the US include larger living spaces, longer commutes and the tight labor market which gives employees more bargaining power.

- **Health of fundamentals** in Asia-Pacific and Europe are more positive as vacancy rates remain close to or below long-term averages in most markets, in stark contrast to North America where vacancy rates are much higher and above long-term averages in all cases.

- **Investors' view of office risk** relative to other sectors varies globally but has increased across the board since the onset of the pandemic due to the acceleration of trends such as remote working resulting in increased vacancy, as well as the economic headwinds facing the sector. Further polarization of the sector means 'stranding' risk has increased for older buildings, that will require major capital investment to meet tenant requirements and regulations.

- **Pricing and availability of debt** for offices is reflective of the relative fundamentals for offices in different regions. Overall sentiment is more negative globally due to the impact of rising underlying interest rates on the total cost of debt. Generally, debt markets remain active for prime transactions but with a much narrower pool of lender liquidity, wider margins and lower LTV's as lenders become increasingly selective. Bank financing is increasingly thin for core deals and out of the market for value-add deals, although alternative lenders are still active in this space at higher margins.

Note: Based on the views and opinions of LaSalle Investment Management Research and Strategy

Office green factors comparison

Green-leading markets likely to see earlier investable brown-to-green strategies

Market segment \ Risk factors (Description)	ESG/NZC tenant demand — Requirement from tenants (positive=an increase in requirements)	ESG/NZC regulation — Local or national regulations (positive=an increase in regulations)
US major CBDs	High	Moderate
US sunbelt suburban	Moderate	Low
London	High	High
Cont. Europe	High	High
Australia major CBDs	High	High
Tokyo 5-Kus	Moderate	Moderate
Shanghai CBD	Moderate	Moderate

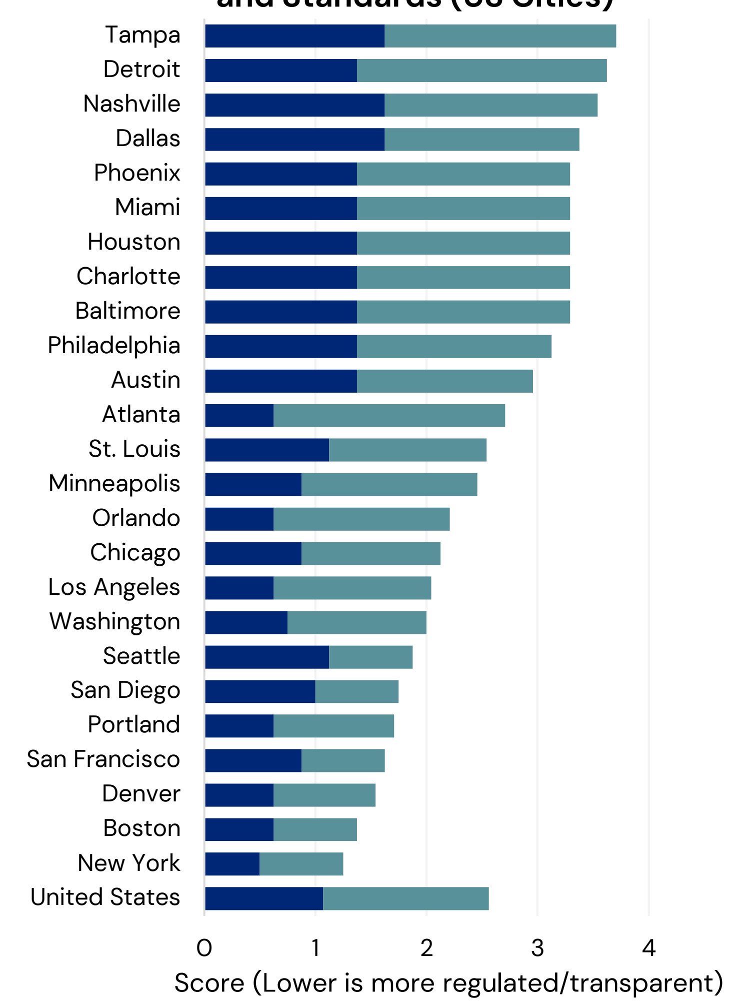
Extent of "green" as driver of outcomes:

- High
- Moderate
- Low

- **ESG/NZC tenant demand and regulations** are having a material impact on office markets, with Europe leading the way. Other regions are not yet seeing the same level of focus on these factors, but they are expected to follow the same path.
- **Simplistically, tighter regulation could be seen as a negative, but it creates potentially large opportunities.** Regulation, measurement and awareness of sustainability factors drives pricing of environmental factors, creating opportunities for brown-to-green investment strategies.
- The JLL/LaSalle Real Estate Transparency Index scores on green reporting standards (see below) gives a sense of which cities and regions are lagging and which are leading.

Efficiency and Emissions – Reporting and Standards (Countries)

Efficiency and Emissions – Reporting and Standards (US Cities)



Note: Based on the views and opinions of LaSalle Investment Management Research and Strategy
LaSalle Investment Management analysis of data from 2022 JLL Global Real Estate Transparency Index (https://www.us.jll.com/en/trends-and-insights/research/global-real-estate-transparency-index)

Investment implications and predictions

LOOKING AHEAD

- The uneven impact of a return to physical offices shows that investors should avoid projecting their country's view of a sector too far away from their home market. For example, office fundamentals remain relatively healthy in Asia and Continental Europe, while they are fragile in the US. Furthermore, changes to office usage will be phased in, leading to a slower recovery as firms re-size spaces for new workspace strategies. Finally, a weakening labor market could tip the balance of power away from employees as employers mandate a return.
- While the balance of in-person and virtual modalities may have reached something close to a steady state, occupiers are in the early days of reconfiguring workplaces. Companies will likely focus more on collaborative spaces and less on rows of desks, with implications for space demand. The key questions have shifted from the amount of in-person work to the precise amount and type of space needed to facilitate interaction and collaboration.
- Modern buildings will outperform older buildings. Plus, office experience and amenities remain critical. As hybrid working becomes the norm, the accessibility, flexibility, technology infrastructure, and amenities offered by the office are crucial to facilitating attendance, talent attraction/retention, in-office collaboration and overall tenant demand. In addition, older buildings need to meet the needs of higher-end tenants (amenities and high-quality air filters and HVAC systems). The net result is more CapEx for most older buildings and some newer buildings.
- Office-associated demand will be hurt more than office demand itself. Office-associated demand (e.g., parking and ancillary retail) is driven by employee days in the office. As firms allow more WFH flexibility, fewer workers will be lunching near offices, taking public transport, or parking daily. This might impact adjacent real estate and office building cash flows tied to retail or parking.
- Given the increasing risks around the office sector, investors should be compensated for higher risk with higher returns compared to lower-risk property sectors.

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