CLUTTONS

RETURN TO THE OFFICE

QUARTER FOUR 2021

Cluttons market reports track investment and occupier activity across the UK office, retail and industrial sectors. This edition focuses on the impact of working from home and its effect on the office market.

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KEY FINDINGS

Contractions in office demand likely

One-third of workplace activities in the UK can be carried out remotely without any loss of productivity; the theoretical maximum for the finance, insurance and professional sectors is much higher, at over 75%. As a consequence, there is high potential for reductions in office space.

Limitations on square footage to be shed

There are restrictions on the amount of space businesses can shed. There will be limitations if, for example, employers need to accommodate high numbers of staff at peak times. This means falls in floorspace will not be directly proportional to increases in home working.

City centre offices to reassert themselves

The appeal of city centre offices will be reaffirmed over the next few years. 'Best in class' offices which can provide environments that support a productive workforce will present the best outcomes for their inhabitants and the lowest depreciation risks for their owners.

INTRODUCTION

For several years pre-pandemic the homework rate was around 5%, compared to 1% in 1981. It rocketed to 37% in April 2020 and remains high as pandemic restrictions ease.

Three lockdowns later and office vacancy has increased (over 40% in Manchester and London and over 60% in Bristol and Leeds). Subletting is up 25% across the UK compared to Q4 2019, and we have seen negative net absorption every quarter since Q2 2020.

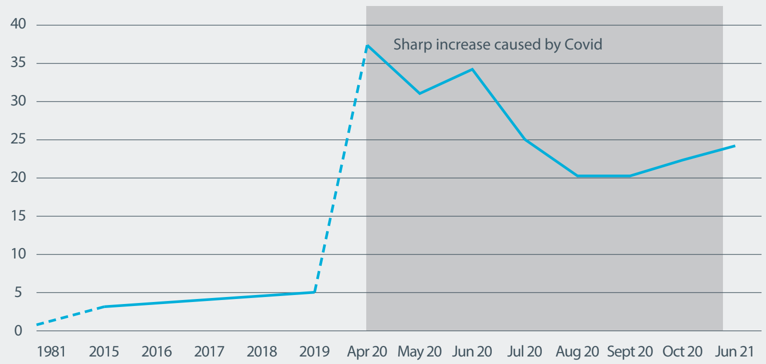
Around 18 million more square feet of office space is being marketed in the UK compared to pre-pandemic; 21.6 million sq ft is vacant in central London, and 61.9 million sq ft across the rest of the UK.

Right now, lack of economic growth (GDP) and low business confidence are exercising decision makers, which makes it too early to say whether increases in vacancy rates and reductions in office take up are temporary or a signal of longer-term structural change.

Surveys tend to show 80%+ employees value some form of homeworking and 50% want to retain it, which suggests it will continue to some extent in the short-to-medium term. But data also indicates that workers wish to return to central business districts - if only for part of the week.

In what follows, we explore the potential impact of working from home and the resultant outlook for office demand.

Figure 1.
Proportion of people in employment working from home, %



Source: Office for National Statistics, Bank of England

In a tightening labour market, employees will have the casting vote

The UK has some of the highest potential for home working globally, with a workforce that can theoretically work remotely one-third of the time without a loss of productivity[1]. Studies by McKinsey Global institute indicate this potential is concentrated in the finance and insurance, professional and tech sectors, where more than three quarters of employee time is spent on activities that can be done off-site. (Figure 2).

Of course 'can' does not mean 'should' and some organisations, including Goldman Sachs and JP Morgan believe work is best done in the office. There are some important assumptions about value creation behind this school of thought. JP Morgan, for example, believe collaboration, innovation and the 'apprenticeship' model of investment banking will be damaged by working from home.

In workplaces with complex team-based work, long hours and an 'up or out' career system, being visible, always on call, and learning from seniors can be critical. In fact, in a pre-pandemic analysis, researchers found homeworkers were 50% less likely to get promoted and 38% less likely to get a bonus[2].

Investment banks are not the only firms have optimised the office as the primary place for work. Pre-Covid, many organisations (most notably Silicon Valley tech and magic circle legal firms) designed employee systems that included concierge services, meals, and health and wellbeing services - these perks prevented employees from being distracted by home life.

Given their somewhat paternalistic model of work, it is perhaps unsurprising that under 50% of businesses within the professional and tech sectors are planning to use home working as a permanent business solution going forward. (Figure 3).

Meanwhile, pre-pandemic workplace models of such firms are being questioned by employees who reconnected with their real home lives during the pandemic, and 45% are considering moving to organisations which support more flexible working[3]. Incidentally, productivity and health data collected before Covid shows that employees working flexibly are, in fact, more productive (up to a day a month according to research by Stanford)[4].

When it comes to working from home, employees will need to balance the perk with other factors, including prospects and pay. In a tightening labour market, when views of corporations and employees clash, talent is likely to have the casting vote.

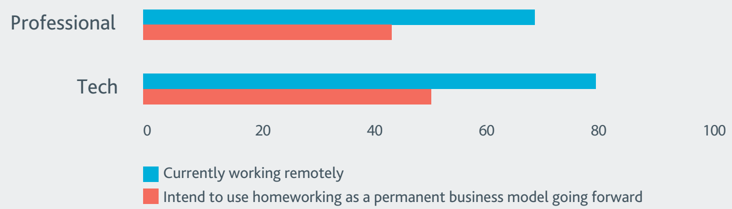
1. *https://www.mckinsey.com/featured-insights/future-of-work/whats-next-for-remote-work-an-analysis-of-2000-tasks-800-jobs-and-nine-countries*
2. *https://www.sbs.ox.ac.uk/oxford-answers/hybrid-working-what-does-it-mean-future-work#_edn3*
3. *https://www.sbs.ox.ac.uk/oxford-answers/hybrid-working-what-does-it-mean-future-work*
4. *https://nbloom.people.stanford.edu/sites/g/files/sbiybj4746/f/wfh.pdf*

Figure 2.
Potential share of time working remotely by sector, %

Source: The McKinsey Global Institute

Note: the theoretical maximum includes all activities not requiring physical presence on site; the effective potential include only activities that can be done remotely without losing effectiveness. Model based on >2,000 activities across >800 occupations

Figure 3.
Businesses planning to stick with homeworking, %



Source: Office for National Statistics Business Insights and Conditions Survey, June 2021

We don't need offices, except midweek

Increased home and hybrid working will mean declines in office demand over the short to medium term. But certain mitigating factors will serve to taper the amount of office space businesses can shed.

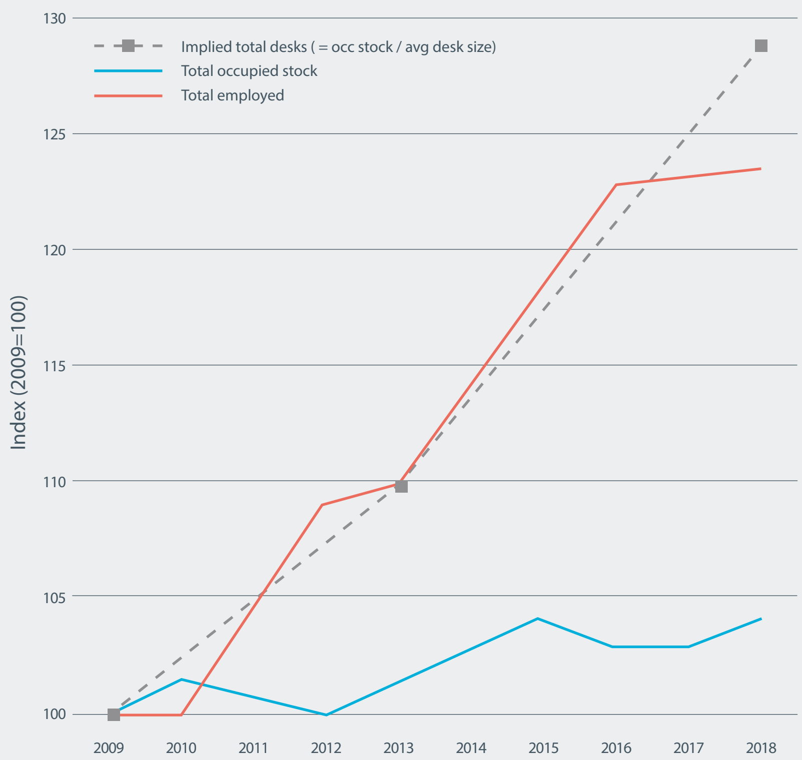
Firstly, it is important to note that occasional homeworking has not led to a corresponding fall in the number of workstations historically (Figure 4). The assertion that increased home or hybrid working will lead to a proportional shedding of surplus space is therefore questionable.

Moreover, workspace occupancy studies from the past 10 years+ have consistently found that desks are occupied on average around 40–50% during the core working day[1]. This makes under-utilised space a decade old issue for businesses.

Even if a large proportion of the workforce stay at home, there will be times when the majority are present (the latest data from Remit Consulting suggests recent returnees prefer Wednesdays, Thursdays and Fridays). If organisations are to accommodate peak occupancy on certain days the potential reductions in office space – and the associated cost-savings – may be limited[2].

1. *https://www.bco.org.uk/Research/Publications/Office_Occupancy_Density_and_Utilisation.aspx*
2. *One option is to restrict the times and days employees can use the office. But under this approach savings in property costs and square footage may be countered by losses in flexibility and employee satisfaction.*

Figure 4.
UK office occupation, employment, and desk growth



Note: This chart compares the growth in office employment (the red line) to increases in occupied office stock (the blue line). The grey line represents the implied number of desks taken up by organisations across the time period. This is calculated by dividing the total volume of occupied office space by the average floorspace allocated per worker (the latter declining from 11.9m2 per employee in 2009 to 9.6m2 per employee in 2018). It indicates that UK office employers have increased desk counts broadly in line with the growth in their staff numbers, and shows no discernable home-desk substitution effect.
Source: Property Market Analysis, Office for National Statistics, British Council for Offices

Intolerable proximities

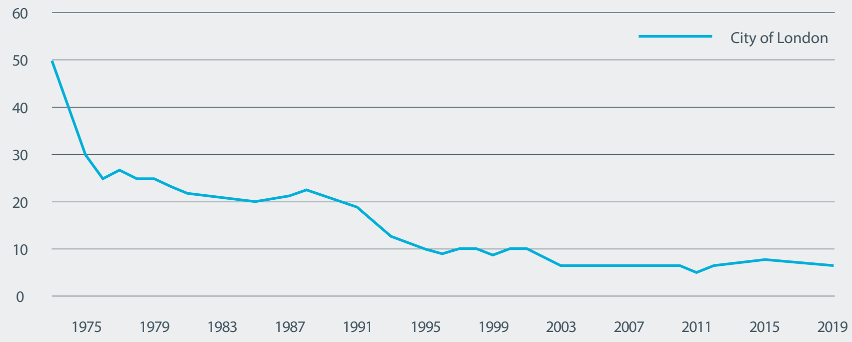
The cost saving argument for space-shedding itself warrants closer attention.

For office-based businesses, real estate costs as a proportion of total costs have been falling for many years; in the City of London, for example, rents are just 5-7% of the total wage bill (Figure 5). Therefore, for those trying to save money, the impact of reducing office space is likely to be marginal. In fact, poor quality, over-densified office space could cost occupiers when it comes to productivity.

Proxemics - the study of the behavioural aspects of spatial distances between individuals - has increasingly shown that being respectful of comfort zones is crucial for employee wellbeing and productivity; this is an important aspect of workplace design. In the 2010s offices in the UK were designed at ratios 1:10, then decreased to 1:8, and sometimes reached 1:6 (just 6 metres allocated per employee). But a backlash against decade long contractions in floorspace per employee has been discernible over the past 4-5 years.

Objections are likely to intensify now that many (formerly) office-based employees have gotten used to working in their own space at home. This may result in occupiers increasing the floorspace allocated per employee, effectively counteracting falls in office demand.

Figure 5.
Office rents as a proportion of total salary, %



Source: Office for National Statistics, Costar, Property Market Analysis

De-densification of the office

Forecasting houses have in the past assumed occupational densities contract over time, which means slower net absorption relative to growth in office employment. Acknowledging the possibility of de-densification, Property Market Analysis (PMA) ran an illustrative exercise around the additional demand that might be created if occupational ratios were to freeze.

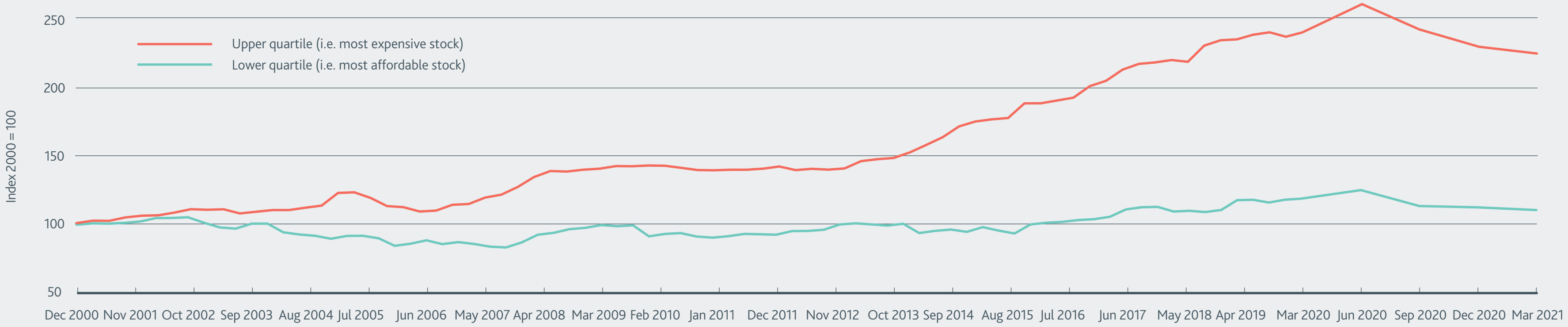
They looked at 5 gateway cities; Boston, Chicago, New York, Los Angeles and San Francisco. Under normal conditions, floorspace per worker was projected to decline by 2.5% over a five-year horizon (this varied by market, with Boston and Los Angeles experiencing relatively limited movement and San Francisco seeing a forecast decline of nearly 8%).

The illustrative exercise found that, all other things being equal, holding floorspace steady across the 5-year forecast period would result in aggregate demand across the five markets increasing by >24 million sq ft. This indicates even a slowdown (as opposed to a reversal) in workspace densification could meaningfully counteract some of the downward pressure on floorspace per worker resulting from increased home working.

Source: Property Market Analysis

Figure 6.

Gross rental growth, Central and Inner London offices



Source: *MSCI*

The office as a value creator, not a cost centre

The principal trend over the past few years is that the office should be a 'value creator' rather than a 'cost centre', meaning it should provide a healthy, productive environment which allows employees to create value for businesses by working as efficiently and effectively as possible (Note 1).

Pre-pandemic, the average time spent commuting per day in the most populous parts of the UK was around 75 minutes. If employees are to invest this time into travelling again, they should arrive in workplaces offering better conditions than those available at home. Those returning to the office will need to be satisfied with communal and informal work areas, have a variety of types of workspace, great décor, IT equipment, seamless digital connectivity, tidiness, cleanliness and good daylighting and air quality (notably, the latter can double cognitive performance amongst workers)[1].

In an analysis from 2017, the British Council for Offices calculated that creating an office space which increases employee productivity by just 1% can have enough positive impact on a business's bottom line to justify increasing property costs by 10%.

We are already seeing a preference for the 'best over the rest' office stock, and this is reflected in the London's market where rental growth for the upper quartile (i.e. most expensive offices) has been outpacing rental growth for the lowest quartile of offices at an increasing rate (Figure 6).

This flight to quality accelerated during the pandemic and is expected to continue in the coming years: while occupiers may want less space, the space they do take is likely to be the very best they can afford. As a result, only the highest quality offices will see significant upward pressure on demand.

1. *https://pubmed.ncbi.nlm.nih.gov/26502459/*

Note 1

A productive workplace enables people and teams to perform at their best by being:

- Healthy - Supporting and improving individual wellbeing at work
- Efficient - making good use of space, time and information
- Effective - enabling people to do their work well
- Engaging - a desirable destination that looks and feels like a great place to work

Source: British Council for Offices, 'Defining and Measuring Productivity in Offices', 2017

Back on the train

There has been, during the pandemic, discussion about placing 'spoke offices'[1] in decentralised locations. This is convenient for workers who would like offices closer to their homes and an attractive approach for organisations that believe current working practices will not erode significantly post-pandemic.

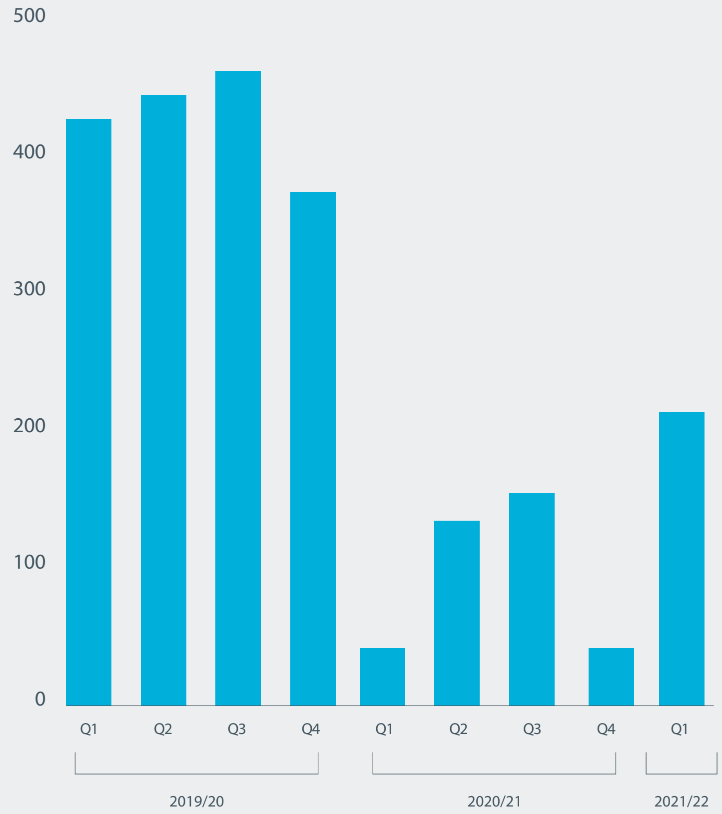
But in reality only a few large businesses can support satellite locations outside central business districts. Even for them, it is hard to choose the right locations (Croydon or Slough?). Moreover, it is difficult to reconcile this strategy with climate warming and ESG priorities (mass transport systems, after all, connect citizens to large urban centres—any dispersal of employees is likely to put more cars on the road).

Ties to existing lease commitments, relocations costs, and the willingness of employees to work from home when needed, mean a swathe of moves out of large cities over the next few years is extremely unlikely. Meanwhile, city centre office use is tentatively re-emerging. In the first quarter of 2021/22, rail passenger journeys were 42% of those made in the same quarter of 2019 (Figure 7) and September data collected from automatic office turnstiles shows over a third of staff went back to the office in London's West End[2].

As the pandemic comes further under control, the logic behind leaving cities is the very same that will attract organisations and employees back (even if only for some part of the week): good connectivity, access to talent and immeasurable agglomeration benefits for workers and businesses alike.

1. *Under a 'spoke and hub' model a company will have a headquarters, which serves as the hub of the business. The spokes are a geographically distributed network of offices usually based on the location of talent (and client needs).*
2. *Based on data from building managers as >150 major office buildings collected by Remit Consulting for their ReTurn report*

Figure 7.
Rail passenger journeys in Great Britain, millions



Source: Office for National Statistics

SUMMARY

Office demand to reduce in the short to medium term

One-third of workplace activities in the UK can be carried out remotely without any loss of productivity. This will result in an increase in home and hybrid working and lessen demand for office space in the short to medium term. The level of home and hybrid working maintained longer term will differ by industry; finance and insurance have the highest potential, with over 75% of time spent on activities that can be done remotely.

Most occupiers face restrictions when it comes to shedding space

Just because certain tasks can be done remotely does not mean they should. Before employers decide to reduce their office footprints they will need to understand their value creation models and decide which activities are, in reality, better done off-site. Importantly, falls in floorspace per worker will not be directly proportional to increases in home working; de-densification will offset some declines and there will be restrictions on how much square footage employers can afford to lose if they want to accommodate higher numbers of staff at peak times.

The advantages of city centre offices will reassert themselves

It is highly likely that the appeal and advantages of city centre office buildings will be reaffirmed in the coming 24 months as GDP and employment return to pre-pandemic levels. The agglomeration benefits of cities are immeasurable and mass relocation elsewhere is unlikely owing to cost implications and lack of optimal locations (as well as employees' willingness to work form their homes).

Only the highest quality offices will see significant upticks in demand

The overriding trend for the future remains creation of work environments that enable a productive workforce—if occupiers want less space, it will be the best they can afford. It will be difficult to attract tenants to offices that, amongst other things, have dated reception areas, poor floor plate configuration, low ceilings, compromised natural light and poor sustainability credentials. In the coming years, only the highest quality offices will see significant demand.

CLUTTONS

Visit us

Cluttons LLP,
2 Portman House
Portman Street
London W1H 6DU

Contact us

T: 020 7408 1010
F: 020 7647 7177

cluttons.com

For further details contact

SOPHY MOFFAT
Head of Research
T: 07970 539 958
sophy.moffat@cluttons.com