The next financial crisis?

Covid-19's office industrial revolution

Abstract

The Government must start preparing for a repeat of the global financial crisis a decade ago as falls in real estate valuations in the wake of the Covid-19 pandemic expose banks to massive losses on their loans against office properties.

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Foreword

The outbreak of the coronavirus and the tough restrictions put in place by governments to control its spread have had devastating impacts on all sections and levels of society and the economy. But when it comes to the way we work — and where we work —the impact is nothing short of a new Industrial Revolution. It is as profound as that.

Restrictions have forced businesses to allow all or most of their staff to work from home. Both managerial and cultural barriers to remote working have broken down while advances in technology enabling online meetings and sharing of material in the cloud have come at just the right time. All of these factors will lower demand for city centre office properties.

Some real estate companies point to measures to mitigate the risk of the virus' spread by making offices compatible with restrictions that may last for years. I do not doubt they will find ways to make buildings safe. But I fear they sound too relaxed: Covid-compliant offices may host just a quarter of previous numbers. The skyscraper's days look numbered.

If employers have less demand for city centre office space, they will want to pay less for it and as the rental income stream dries up so valuations must fall. Besides the obvious impact on owners, the real worry is the impact on banks that have lent against commercial property. The global financial crisis of 2008/09 showed how it was banks that ended up with the losses when it was impossible to identify a value for assets in illiquid markets.

Governments have intervened to support employees and businesses including allowing tenants to withhold rental payments. But so far there has been no discussion of the financial help that will be needed if a health crisis turns into a financial catastrophe for owners, investors, and lenders. Now is the time to start planning for that.

— Jonathan Harris CBE, FRICS

Executive Summary

The deadly and highly contagious Covid-19 disease has changed the way millions of office workers do their jobs and live their lives. Many workers in towns and cities in the UK and continental European countries now work from home in line with government advice. Many employees like working from home and those who do all of their paid work at home report they are getting more done per hour than before lockdown.

Employers say productivity has not been impacted and has even improved. Firms are looking to cut their real estate footprint as they realise they will need office space for fewer employees when their leases expire. Affordable technological equipment has meant many employers have allowed some staff to work from home on a long-term basis.

Investment institutions forecast demand for office space might fall up to 35% exacerbated by rising insolvencies. As rents fall, the value of real estate in cities could fall sharply over the coming years, which in turn could affect the credit quality of debts in the sector.

If landlords fail to meet interest charges or repay loans, an economic crisis will quickly mutate into a financial crisis as existing loans are deemed impaired and lenders rein in new lending. This could lead to corrections in prices that would swiftly become a vicious cycle as was seen in the market for complex asset-backed securities in 2009. Governments must start planning now for rescue packages for the banking sector.

Introduction

As of early October 2020, the geographical continent of Europe has experienced more than 5.4 million confirmed cases of Covid-19 and more than 225,000 deaths.[i] The lockdowns ordered to contain its spread have devastated its economies. Within the space of a few months, the outbreak of the deadly and highly contagious Covid-19 disease has changed the way that millions of office workers do their jobs and live their lives. A large chunk of the workforce in towns and cities in the UK and continental European countries now work from home (WFH) in line with government advice. Many offices have skeleton staffs and once busy business districts are silent. It has been nothing short of a 21st century industrial revolution.

With infection and death rates rising again in many countries, governments are imposing new restrictions on travel and gatherings and issuing updated advice on the need to work from home. While some workers had returned tentatively to their usual place of work, it is clear that many employees and major employers now believe there will not be a return to the pre-pandemic patterns of office work.

To some extent Covid-19 has accelerated trends that were already visible. Technological innovations and falling prices for many once unaffordable pieces of equipment has enabled many employers to allow some of their staff to work from home, safe in the knowledge that they can operate as if they were in an office. Many others have found it easy to set up their own businesses from home.

This dramatic change in work patterns raises a question mark over the future of the office, that until now has represented the normal place of employment for millions of workers in Western economies. This report looks at whether Covid-19 and other underlying changes will make the office redundant, at least in its current form. It will examine whether less office space is needed and how the buildings that remain as offices will change in order to adapt to the post-Covid environment.

The pandemic has also generated many questions for commercial property owners, developers, and tenants alike. Firms have been left paying high rents on offices they are hardly using, which in turn leads to cashflow problems. Some businesses that rent office space may even face bankruptcy or decide to shift to an entirely WFH model. This may have a dramatic impact on the value of office buildings: rental and asset values could fall. This raises the real prospect of property owners breaching debt covenants, and suffering credit downgrades that could leave lenders nursing heavy losses.

1. Behaviour shift: employees are working from home and they like it

Many people who can work from home are doing exactly that. Employers have heeded government advice and registered their employees' concerns about the risks entailed in commuting to work where they expose themselves to risks both while travelling and from their proximity to colleagues in a closed environment. By April almost half of British workers were working from home (46.6%), according to the Office National Statistics[ii]. More than half of people living in London (57.2%) did some work at home. Among occupations that are wholly or primarily done in an office, the figure was almost seven out of 10.

A survey of workers across the EU by Eurofound showed that in July nearly half of employees surveyed (48%) worked at home at least some of the time during the Covid pandemic. Of these, more than a third (34%) reported working exclusively from home.[iii] However, continental European employers and workers have shown a greater willingness to return to work. A survey by AlphaWise, the proprietary survey and data arm of Morgan Stanley Research, for Morgan Stanley in August showed only just over a third of UK office staff had returned to their normal workplace, compared with 83% in France and 76% in Italy[iv]. The reasons are unclear although at the time the health crisis was reducing on the Continent and governments were seen to have acted swiftly to contain it — the picture is now much less clear. In any case, the potential for homeworking across the EU is immense. Analysis of more than 130 occupations by researchers at the European Commission and Eurofound found that more than a third of jobs in the EU27 could technically be carried out remotely.[v] In the United States, a similar pattern emerges. A survey by AlphaWise found 50% of respondents were WFH in the US. The base case forecast by the parent bank's US economics team assumes a longer-term 30% WFH rate.

2. **Productivity has risen not fallen**

The evidence so far is that employees working from home like the new arrangements. Nine in 10 British workers who have worked from home during lockdown would like to continue in some form, according to a study by two universities.[vi] Furthermore, employees with little previous experience of homeworking had not been put off by the experience of WFH with exactly half saying they would like to WFH often or always even when Covid-19 restrictions permit a return to "normal" working. The report also found that employees who did all of their paid work at home said they got more done per hour than they did before lockdown.

This may explain why employers have been receptive to the new ways of working. Two thirds of UK employers reported home workers were more or as productive as when in the workplace, according to a survey by the Chartered Institute of Personnel and Development.[vii] Overall, 28% of 1,046 employers surveyed reported that the increase in WFH had boosted productivity, while 37% said it had not impacted productivity levels, with 28% of employers reporting a decrease. Employers expect the proportion of their workforce that WFH regularly to double to 37% on average after the crisis is over, compared with the pre-pandemic average of 18%. Employers told CIPD they expected the proportion of the workforce that works from home all the time to more than double to 22%, compared with 9% before the crisis.

These changes to working patterns are likely to be permanent. That is so much because of temporary government regulations but far more because of people's preferences and performance. For employees it has eliminated the stress, waste and cost of commuting and (for most but not all) improved their work/life balance. This perception of improved productivity by both employers and employees reinforces that.

3. **Restrictions force employers to plan for post-Covid future**

Employers who have moved towards re-opening their offices have found they need to limit the number of workers who have access to any given space at the same time, in order to ensure social distancing. The workforce may be divided into rotas to allow phased entry to avoid overcrowding at the entrances. The number of desks per square metre will have to be reduced. Access to staff bathrooms and canteens will have to be regulated or, in the latter case, perhaps closed. Use of lifts will have to be rationed to ensure people keep one or two metres apart: this will be especially time-consuming and debilitating for people working in very tall buildings. On top of this, employers or landlords will have to provide personal protective equipment, such as hand sanitiser, masks, and gloves. They — or their tenants — will have to adopt property technology solutions such as robots that can detect contagious particles and sanitise and clean office space. Extra janitorial services will be needed to disinfect items such as elevator buttons and taps. However, for now much of this will have been on hold in the light of the latest UK government advice that office workers should WFH if they can.[viii]

It is clear that many employers are planning for this new formula of increased WFH and lesser use of office space. A survey of almost 1,000 company directors in September found that nearly three quarters (74%) said they would maintain increased WFH after coronavirus.[ix] As early as May, several CEOs of large companies were happy to go on the record about their plans for decreased use of office space. Jes Staley of Barclays said: “The notion of putting 7,000 people in a building may be a thing of the past.” Dirk van de Put of Mondelez opined: “Maybe we don't need all the offices that we currently have around the world.” Ben Looney at BP is looking at having 50,000 employees WFH that would allow a halving of office space[x]. And Sir Martin Sorrell, the former chief executive of advertising giant WPP who now runs S4 Capital, said WFH would herald a “permanent change” to his working practices. “I spend around £35m on property in a year,” he told the *Financial Times*. “I'd much rather invest that in people than expensive offices.”[xi]

It should be no surprise that companies are eyeing up savings to be made. A survey by consultants PwC in June found a third of chief financial officers in the US were already thinking of cutting back on their real estate footprint.[xii] Managers have realised that while all of their employees will probably be WFH at least one or two days a week, they will need office space only for collaborative and other kinds of interactions that cannot be done remotely. Many services companies in both the public and private sectors are certain to downsize office space — healthcare providers being an obvious exception.

4. **Business districts will lose their sparkle**

Employers are starting to look at new locations away from city centres and urban business districts. They can see their workers are content to be closer to home rather than undertaking long commutes. At the same time, city-based employees are increasingly looking for three- and four-bedroom houses with space to WFH. Big homes in the countryside are shifting fastest, while urban flats typically aimed at first-time buyers are now the slowest market segment, according to one survey.[xiii]

If office space is only needed for collaborative meetings or for people who cannot WFH — a kitchen table, sofa, bed or decaying garden shed may not be an acceptable replacement for an office desk — then the answer could be smaller working spaces closer to where people live.

According to IWG, a flexible workspace provider, the Covid-19 pandemic has prompted a shift from big city centre offices to smaller suburban work hubs, partly due to employees' reluctance to use public transport. These centres are likely to benefit as a result. The company, which has office space in more than 1,100 towns and cities, said in August that a structural shift away from city centres and towards a hub-and-spoke model, with a city centre office but an array of smaller satellite offices in suburban or rural locations, was underway before the pandemic but had accelerated. As its chief executive Mark Dixon, put it, while people have "tasted the relative luxury of not having to commute, they do not want to meet clients in their front room or bedroom".[xiv]

According to McKinsey, the coming transformation in workspace will see a portfolio of space solutions: owned space; standard leases; flexible leases; flex space; co-working space; and remote work. It points out that rent, capital costs, facilities operations, maintenance, and management make real estate the largest cost category outside of pay for many organisations. Its research shows this often amounts to 10%-20% of total personnel-driven expenditures.[xv]

5. Brave new working

The death of the office may have been exaggerated but it is clear that the multi-story behemoths that dominate many city skylines and the town-edge business parks made famous by the BBC's *The Office* will have to adapt to find a new role. As occupancy rates decline and costs of running Covid-compliant workspace increases, the real estate sector will need to find a new normal.

Lease rates are likely to decline, and employers and landlords will need to negotiate competitive facilities management contracts for ongoing workspaces. Real estate companies must collaborate with businesses and their human resources departments to plan the internal footprint entirely from scratch. Architects and designers must develop new fit-for-purpose layouts quickly in collaboration with property owners, landlords and employers' groups.

That may preserve some office buildings especially in prime locations such as the City of London. However, the prevalent trends point to a decline in the use of traditional office space and an increase in suburban offices to complement a larger number of people working for longer periods from home.

This raises the question of what alternative uses can be found for office blocks that turn out to be redundant — or to borrow a phrase from the environmental debate over oil and gas reserves, "frozen assets". One clear alternative is for residential use to help meet strong demand for new housing. Converting existing office space would avoid the local battles that often emerge over plans for new homes on greenfield sites.

Since 2015 the UK Government has allowed some offices to be converted into residential use in England under permitted development rights (PDRs). It has stated that more than 60,000 homes have been provided in this way over the last four years.[xvi] However many of these conversions have made the headlines for all the wrong reasons, with reports that some developments have left thousands of people in tiny flats, far from schools and shops. Flats are as small as 20 m², 15 m², or even 10 m².[xvii] Housing Secretary Robert Jenrick has admitted a "minority" of developers have delivered small homes without justification and has responded with a new standard on space that begins at $37m^2$ of floorspace for a new one bed flat with a shower room ($39m^2$ with a bathroom), ensuring proper living space for a single occupier.

There is also the potential for the revival of housing above office or single- or two-storey office or retail space that could help meet demand from people who want to live and work in more suburban or town locations. One type of development allowed under the new PDR rules is for building new flats above a range of commercial premises or mixed-use buildings. It only applies to buildings constructed between 1948 and 2018 and there are various hurdles set out in the Statutory Instrument that need to be overcome.[xviii] If the government is serious about enabling uses for office property, they will need to revisit the PDR. There are already signs this is underway: John Lewis is planning to build rental homes above or beside Waitrose supermarkets. It aims to build new homes above or beside 20 stores and will also review the development opportunities of other properties it owns. [xix]

Real estate owners, landowners and financial institutions holding commercial real estate debt must embrace a brave new world that sees some central office blocks crying out for new uses but at the same time demand for suburban office integrated with housing as trends towards working from home continue.

6. Implications for office real estate

All the factors highlighted in this report — social restrictions, the need for spaced out working, lift access, the trend towards WFH, stable or higher productivity among WFH employees, and the greater demand for suburban offices — have cast real doubt on the valuations that property companies and their lenders hold on their books.

Right now, it is very hard to get a meaningful value for office space as very few property companies will want to put real estate on the market in the middle of the pandemic. Without any meaningful transactions, it is very hard to get a true market value. RICS, the professional body for chartered surveyors, has warned that “in considering the degree of uncertainty at a specified valuation date, and where valuing in accordance with the market approach, careful regard should be had to the level of activity in the relevant market and the existence, and degree of reliability, of recent or contemporary evidence”.[xx]

As was clear during the global financial crisis, valuing illiquid assets becomes challenging during periods of economic contraction, partly due to the amount of debt behind these assets. Meanwhile overseas buyers will be affected by travel restrictions and will find it harder to undertake transactions. As rental streams dwindle the book value of the office space will fall, impacting both the real estate company and its financial lenders, as the example in Box A shows.

Box A: Worked through example of an office valuation

Take the example of a hypothetical well-located office block of 50,000 sq ft to host 500 workers, that would have attracted a pre-Covid rental price of £100 per sq ft, or £5m a year. Last year that might have been valued with a multiple of 25 producing a value of £125m. Again, assume that a Bank lent against two-thirds of that value secured with an £85m loan. That leaves the Company with an equity value of £40m.

In 2020 social distancing is likely to halve the number of people the office can safely host, so the rental value of the office building would fall to £50 per sq ft i.e. £2.5m a year. The Occupier might decide that its pre-Covid office of 100 person now only needs to accommodate space for 25 people as the other 75 will work from home.

In this example a pre-Covid rental cost of £5m a year has fallen to a post-Covid rental of £250,000 — as a result of WFH the occupier makes an enormous saving.

However, the position of the property Owner is very serious. The valuation multiplier will have fallen from 25 to say 16 — and when applied to the new rental value produces a new capital value of £40, compared to a pre-Covid value of £125m. But there is still the loan of £85m!

This theoretical analysis also casts doubt on the idea that conversion to residential apartments will be a panacea for unwanted big office blocks. In this example a 50,000 sq ft office will only produce at best 55 flats — the "site price" per flat is about £750,000. But when taking into account the cost of refurbishment — including a profit — the flats would need to sell at more than £1.25m each — a pretty tough call even in the City of London.

And the Bank that made the original loan is also in an unhappy situation — a loan of £85m against security of only £40m.

There is evidence that tenants are already putting pressure on owners to negotiate cuts in rental agreements. An analysis of the property markets in Germany, France, Spain and Italy by Natixis, the French investment bank, forecast take-up of office space would decline by 30%-35% from the levels reached at end-2019, in line with what has been seen in the previous economic downturns in 2002 and 2008-09.[xxi]

In September, S&P Global Ratings, part of Standard & Poor's, found that the second quarter of 2020 was extremely weak for leasing activity in most European office property markets. It said demand for office space in 2020 was far below the five-year average in major European cities. While it said rents had remained "relatively resilient", it observed a widespread trend of declining occupancy.[xxii]

There is also emerging evidence of falling values. In the six months covering the onset of Covid-19 in the UK, values have fallen by 4.0%, according to real estate services and investment firm CBRE.[xxiii] Natixis expects continental European offices to suffer significant drops in capital values through to the end of 2021. The Paris prime office market could lose 10% of its value, while the drop could amount to 20% for the biggest German and Italian cities. This may be a massive under-estimate as Covid has accelerated a trend already underway. In 2017 Fitch Ratings, a credit rating agency, published a report on the disruptive potential of suburban shared workspaces to steal market share from central London prime offices, which it estimated could have shrunk 25% in aggregate value by 2027.[xxiv]

Early on in the crisis, S&P Global Ratings said measures to contain Covid-19 were eroding the credit quality of real estate investment companies in Europe as tenants started to skip rental payments. It said most real estate companies were temporarily easing payment terms, mostly shifting from quarterly payment in advance to monthly in arrears.[xxv]

Fellow rating agency Fitch Ratings has said the coronavirus pandemic will irreversibly change European office markets by causing a step-change in working practices in the information services sectors.[xxvi] It increased its office structural vacancy assumptions with a particular focus on expensive and highly centralised office markets in large cities, such as London and Paris. It said this would cause workers and managers alike to question the merit of traditional office working patterns as the cost per worker of occupying such offices rose.

This could have serious implications for the financial viability of banks — and ultimately for financial stability — if real estate companies fail or debts related to loans against property are downgraded. Moody's, the other major credit agency, warned in August that several German banks faced significant risks from their commercial real estate exposure. The total volume of lending to the sector in the European Union was estimated to be around €1.6tn in 2019, with German banks accounting for 27% of the total. Depending on the length of the crisis, it said it expected payment deferrals, defaults, and declining collateral values to result in deteriorating asset quality, increasing non-performing loans and provisioning needs, as well as reduced earnings.[xxvii]

While this would not be the only factor facing banks, whose corporate loans will be under pressure from Covid-19 across a number of portfolios, it will only add to the pain. An analysis of the US market by the *Wall Street Journal* found that commercial real estate loans that fund malls, warehouses, offices, and other business properties make up about 22% of banks' loan portfolios.[xxviii] Strains are already showing up in commercial real-estate lending. It said the delinquency rate — measuring loans 30 days past due, or beyond — on commercial mortgage-backed securities (CMBS) that include real-estate loans was 10.32% in June, just below its 2012 peak. CMBS were one of the products that was at the centre of the 2008/09 global financial crisis.

Banks and other lenders will be watching to see if landlords start to struggle — or refuse — to meet interest charges or repay loans. If that happens it will be easy in that scenario for an economic crisis to mutate into a financial crisis as existing loans are deemed impaired and lenders rein in their lending. This could lead to corrections in prices that would swiftly become a vicious cycle as was seen in the market for complex asset-backed securities in 2009, which ultimately led to a series of state bailouts across Europe and America.

Already, many real estate investment trusts (REITs) — companies that own, operate, or finance income-producing properties — have suffered a hit to their share prices and are likely to sell assets to pay down debt. REITs for which retail property accounts for at least half of the portfolio suffered average share price falls of 46% in the first nine months of 2020, compared to an average drop of 25% for all REITs and a 20% fall for the FTSE All-Share, according to a press report in September.[xxix]

Governments across Europe and north America have spent billions on supporting employers and businesses whose ability to work has been seriously diminished by the virus and the measures needed to steam its spread. However there has been no discussion about the potential safety net that will need to be put under the real estate sector and the banks that have lent against it. Ten years ago, it emerged that banks were holding complex derivative products, many of which were linked to property assets, that turned out to be worthless when the credit crunch hit. As banks and other lenders were forced to account for trillions of assets that turned out to be valueless, it became swiftly obvious their failure would trigger a new Great Depression without bailouts by the state. With values of office real estate likely to fall like a stone, governments must start planning now for the possibility of another property-based financial crisis.

7. Conclusion

This report is not a forecast but a warning to the office real estate sector whose world has been turned upside down by Covid-19. The dramatic metamorphosis in formerly office-based work is probably here to stay. By the time a vaccine is proven to work and widely available, WFH will have become the norm and firms will have needed a much lower office footprint. If commercial property values do then fall sharply, owners' ability to repay or roll over their loans will be impacted.

As delinquencies on both loans and more complex products such as CMBS start to rise, banks, lenders and investors should brace for losses. This does not mean there will be a re-run of the 2009 GFC: banks are much better capitalised and, in the UK at least, tenants cannot simply hand back the keys. Central banks have shown they are willing to use unconventional policies to keep liquidity in the market — in the words of Bank of England Governor Andrew Bailey to "go big, go fast".

These negative scenarios may not crystallise but there are urgent questions that government, property owners, and lenders and investors must answer: Are you prepared? What strategies do you have in place? Taken together the potential consequences for commercial property are truly revolutionary while the collective answer has so far been tactical when what is needed is a strategic and visionary response.

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