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Global office report – A two speed market?

INSIGHTS

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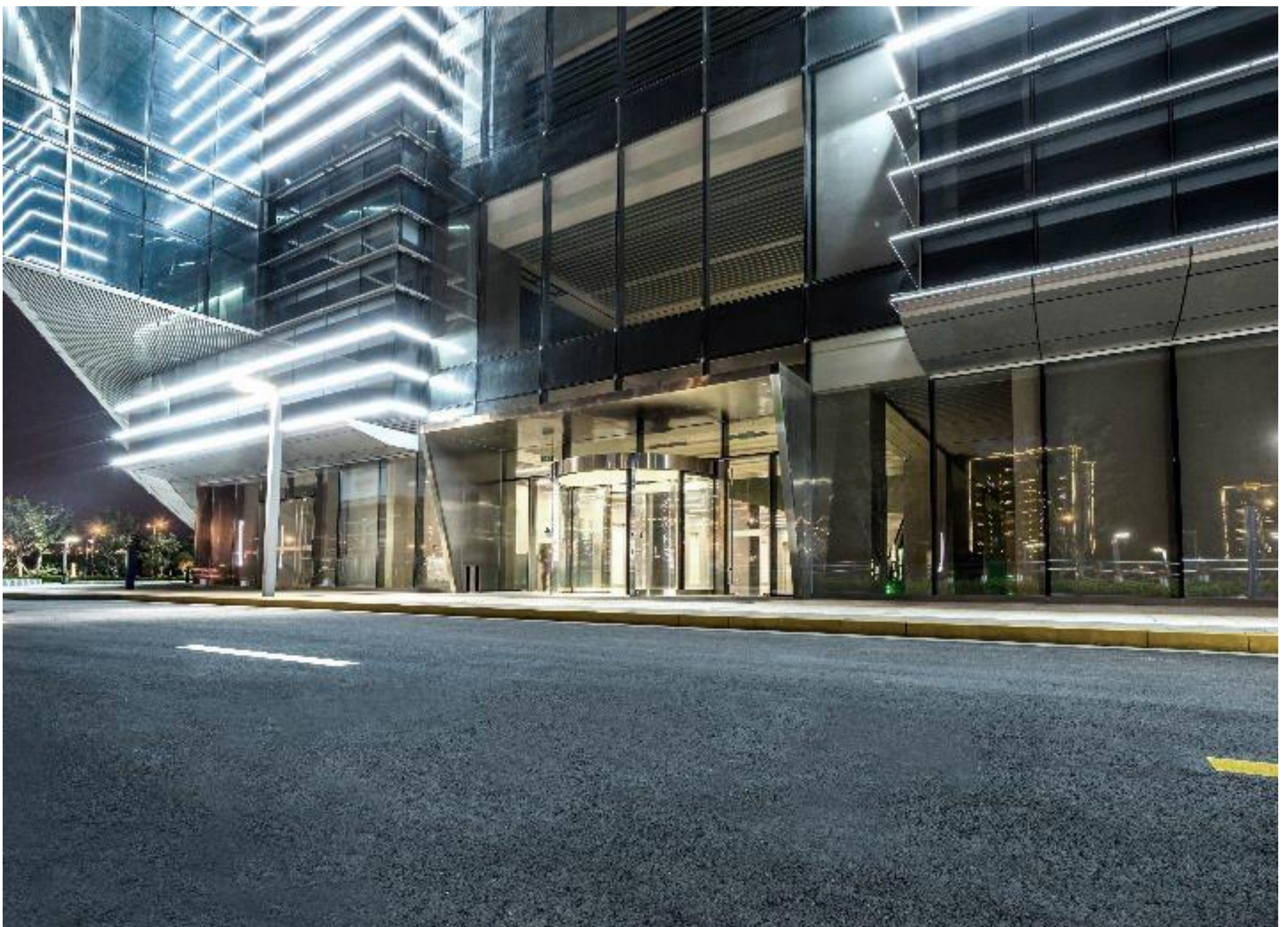

Summary

- This report looks at six of the largest office markets globally, namely London, Paris, New York, San Francisco, Sydney and Tokyo.
- The office still plays an important role, however existing pre-pandemic trends such as highly amenitised offices and ESG compliant buildings have accelerated over the course of the past two years, leading to an uneven recovery in the sector.
- It is not unusual to see a 'flight to quality' during times of market volatility, the difference now is we believe it to be structural, with the 'Green Premium' for ESG compliant buildings set to get larger.
- Globally, government regulations around ESG will increase, as countries look to meet their net zero carbon goals in the coming decades.
- We have seen evidence of bifurcation across office markets globally, with Grade A assets having proven to be more resilient over the course of the pandemic. However, it is important to note that there are regional discrepancies.
- Going forward, the sector will be driven less than initially thought by hybrid working and more focus will be placed on employee wellbeing, exceptional amenities, high connectivity and ESG for the sector.

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Introduction

The global pandemic has accelerated existing trends as well as created new structural trends within the office sector. ESG was a topic of rising concern pre-pandemic, and attention on factors such as the carbon footprint of a building, the health and wellbeing of tenants has only intensified over the past year or two. Energy performance and green credentials are increasingly being demanded by both government and tenants in many countries, accelerating obsolescence in many parts of the office market.

We are also beginning to see a bifurcation in the sector, with the rise in both hybrid working* and more stringent environmental regulation around buildings translating into a divergence in performance between best-in-class assets and the rest. The hybrid working models that have emerged following the COVID-19 pandemic highlights the large structural changes impacting the office market. We will not try and quantify the expected change in occupier demand arising from homeworking but rather look at what a resilient, future-proof office will need to offer. In Europe, we have downgraded the impact of WFH on office demand from our initial projections in 2020, and although still a dampener on occupier demand, we believe the more important factor driving demand now is ESG compliance.

Even though the office sector is going through profound changes, we still see opportunities. Indeed, one of our global preferred equity strategies is investing in best-in-class smart, amenitised and energy efficient offices. Smart amenitised offices include office assets which are highly adaptable, tech enabled and healthy spaces that empower a flexible and productive workforce. These buildings also have high ESG rankings/credentials. (For a detailed look at global green building certification standards, please see the appendix.)

Office layouts, desk densities, occupier wellness and smart technology are just some of the structural changes happening in the sector post-pandemic, and which every office landlord will need to stay ahead of to ensure a resilient, future proof asset.

This report will look at six of the largest office markets globally and examine the state of the current market as well as look at evidence for the structural changes mentioned above.

*In this report, we do not try and quantify the impact of hybrid working on occupier demand, We have previously looked at that. Our analysis can be found here (US version) - https://www.cbreim.com/insights/reports/future-of-office

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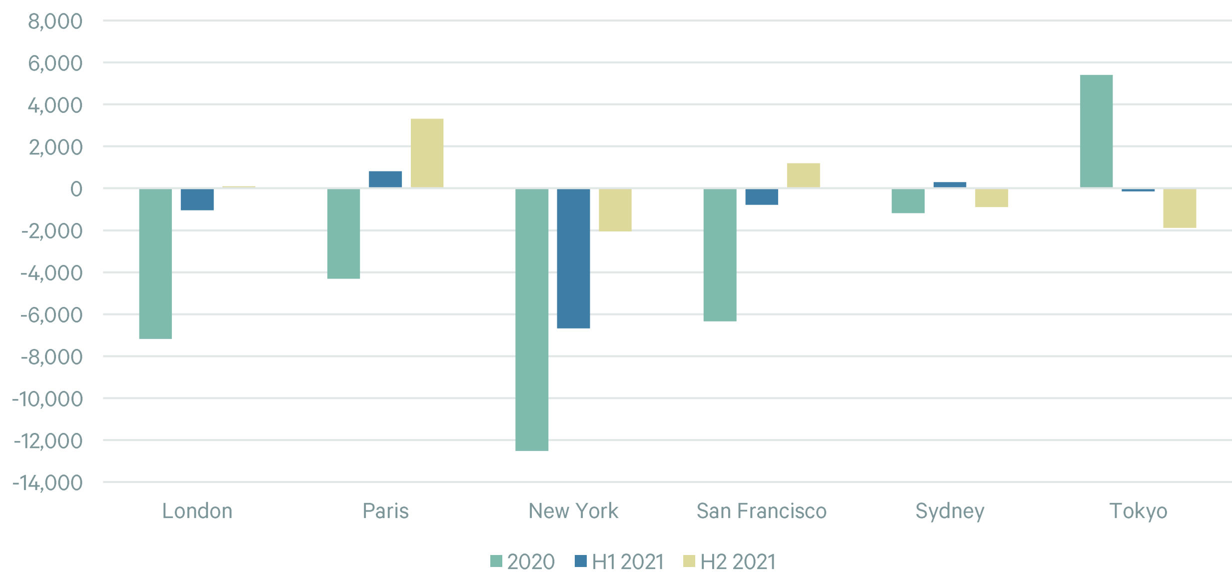
Bifurcation of the Sector

The global pandemic upended working habits, with the mass adoption of remote working. This has had severe ramifications on the office sector, with tenant demand collapsing in 2020. Green shoots have begun to appear in some markets although occupier demand remains moribund in many markets (chart 1).

Chart 1 – Net absorption (sq. ft., 000s)



Source: CBRE.

That said, the hybrid working model, with employees splitting their time between the office and home has become entrenched in the majority of companies either voluntarily or through necessity. In terms of what this means for future occupier demand, there is still a lot of uncertainty as occupiers themselves are still deciding on their own future work practices.

What the headline net absorption figures hide is the significant divergence between what we broadly categorise as prime and non-prime segments of the market. The granularity of data for net absorption between these two segments is usually lacking, but the two markets we have data (Tokyo and Sydney) indicate a far larger decline in the net absorption within the secondary segment.

The divergence in both segments is clear when looking at the change in vacancy rates for prime and non-prime assets across the markets (chart 2).

Out of the six markets in this report, all recorded significantly larger increases in non-prime vacancy rates relative to the rise in prime vacancy rates. Tenant demand remains concentrated in best-in-class office buildings, with secondary market lagging. This divergence is most stark in London and Paris, where prime vacancy rates declined and remained broadly flat respectively.

Other markets such as New York and Sydney recorded a less pronounced divergence between prime and secondary vacancy rates. In the city sections we explore the individual city markets in more details.

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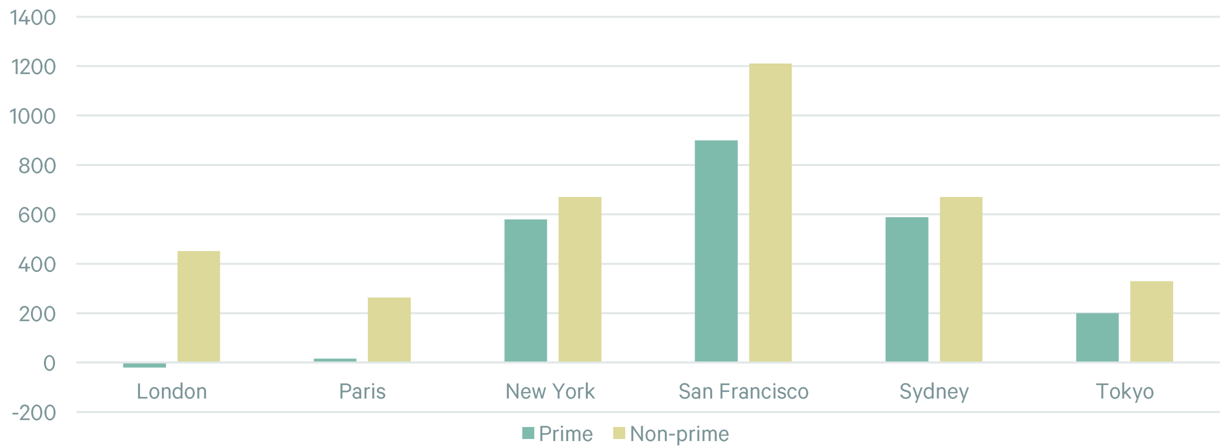
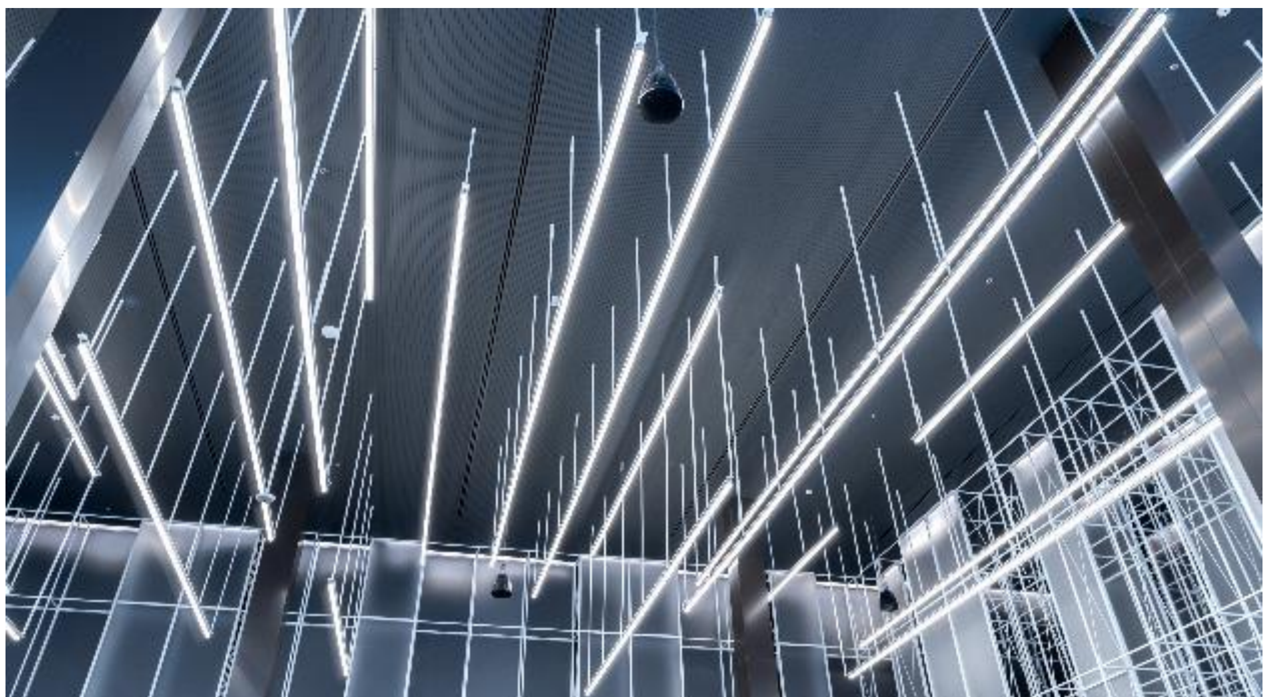
Chart 2 – Absolute change in office vacancy rates (bps) Q4 2019 – Q4 2021



Sources : MSCI, CBRE.

The New York office market has been the hardest hit during the pandemic and the slowest to recover. Looking at commuter data, public transport usage might be an impacting factor. According to City Mobility data analysed by Deloitte, in New York 33% of commuters are using public transport (in 2018). Given COVID-19, people tend to avoid public transportation, hence fewer workers might commute into the office and instead opt to stay working from home, which may result in a slower recovery for the office sector. The only gateway market in our analysis that has a higher usage of public transport is Tokyo (47% in 2018), but due to cultural differences (addressed later in this report), Japanese workers to a larger extent have gone into the office during the pandemic. This is also illustrated by Google Mobility data.



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Green Premium

Government, corporates and society all now demand increased sustainability. In light of this, it has become a strategic imperative for investors to take this into account. Government legislation is becoming more stringent around energy efficiency in buildings.

This has significant implications for the office sector, as many older buildings will no longer meet the new regulations and will need a large amount of CAPEX to transition, or buildings in secondary locations where it will no longer be financially viable to retro-fit. This will result in 'stranded' assets, or brown sites.

Since 2015, there has been a raft of papers showing evidence of a 'green premium' for office buildings, indicating a strong link between energy efficient offices and higher rents or capital values. Our own research confirms these findings. We recently looked at the impact LEED certification has on rents in the US, based on a sample of over 190,000 buildings. We found a 6% rent premium for certified over uncertified buildings of equivalent type.

Some markets are further ahead in the journey to net-zero emission standards through a combination of stricter government regulations and a greater push by both investors and tenants in those countries. That said, the vast majority of office markets in developed countries will see this green premium rise as sustainability standards rise globally.

This is now feeding into an increased divergence between prime and secondary assets in terms of both rents and capital values. Whilst it is not unusual in recessionary periods to an increased divergence in performance between these two office classes, we believe it is more structural post-pandemic as ESG regulations are only going one way.

We analysed the performance of Green Star office buildings in Australia's three largest office markets (Sydney, Melbourne and Brisbane), over the past five years. Green Star prime office consistently beats the all prime office segment at the operating level across different time periods.

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Office Stock – Age Profile

The impact of this divergence will vary significantly city by city, depending on the age profile of each city's stock. Older buildings, especially those built pre-1995 are likely to need extensive CAPEX to meet both regulator and tenant needs.

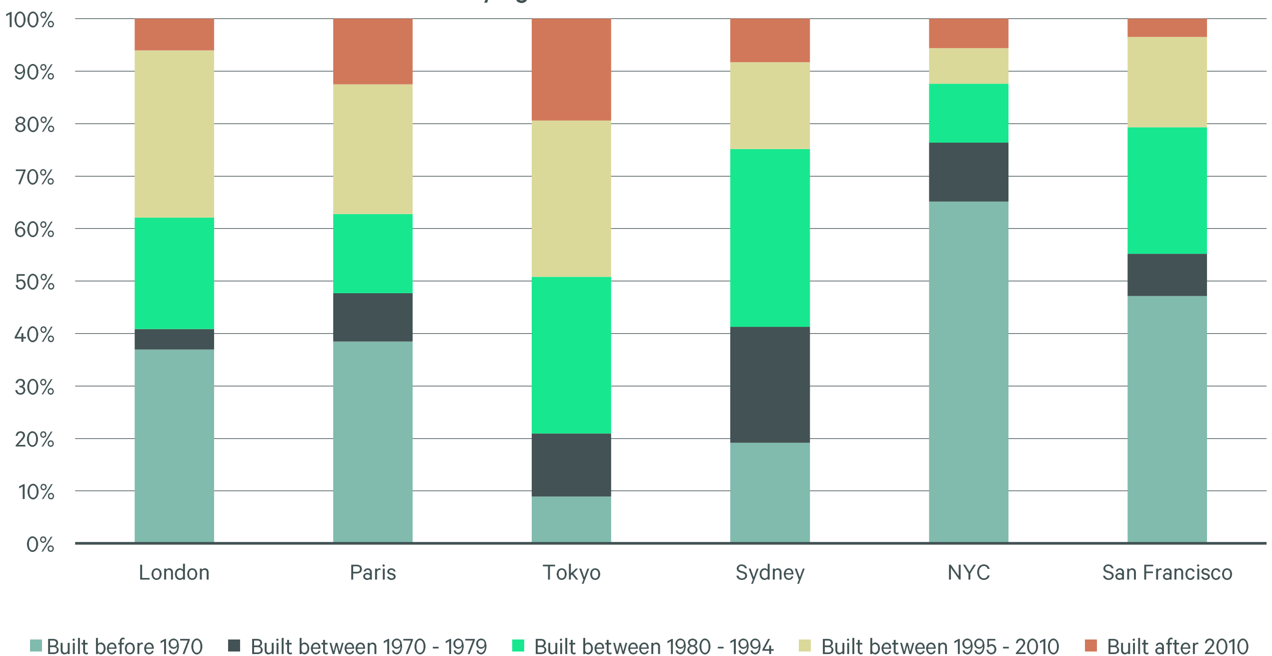
Chart 3 below looks at the age profile of office stock by city. One caveat on this data is that apart from Sydney and Tokyo, the age of stock in the other four cities are only estimates based on the sample from MSCI (Europe) and NCREIF (US). It has been widely noted that due to increased cross-border ownership especially of trophy assets in these gateway cities, there could be an under-representation of newer buildings in our sample. In addition, this data does not account for refurbishment of buildings.

Starting with the European cities, both London and Paris have just under 40% of office buildings built before 1970, with not much built in the 1970s. Just under 40% has been built post 1995, with the Paris office market containing more buildings built post 2010. Apart from Tokyo, the two European cities have the highest percentage of overall stock built post-1995. Turning to the Asia-Pacific office markets, Tokyo by average age of stock, has the most modern profile. Less than 10% of its stock is built pre-1970, and almost half of its stock is built post-1995 suggesting it will be best placed to manage the transition into higher ESG standards. Sydney's largest vintage is the period 1980-1994, with a third of all buildings built in that period. It has just under a quarter of all buildings built post-1995, but only 8% built after 2010.

Moving to the US cities, New York and San Francisco have the highest percentage of buildings built pre-1970, with 65% and 47% respectively built in this period. Only 12% of buildings in New York have been built post-1995.

When we add to this the high percentage of people who use public transit in New York to commute, the reasons for the larger than average impact COVID-19 and the resulting changes in occupier demand have had on its office market start to emerge. Going forward, office markets with older office stock such as New York will likely see the largest divergence between best in class and the rest.

Chart 3 – Breakdown (%) of office stock by age



Sources: MSCI, ONS, Sanko Estate, Cityscope, NCREIF.

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City Sections

London

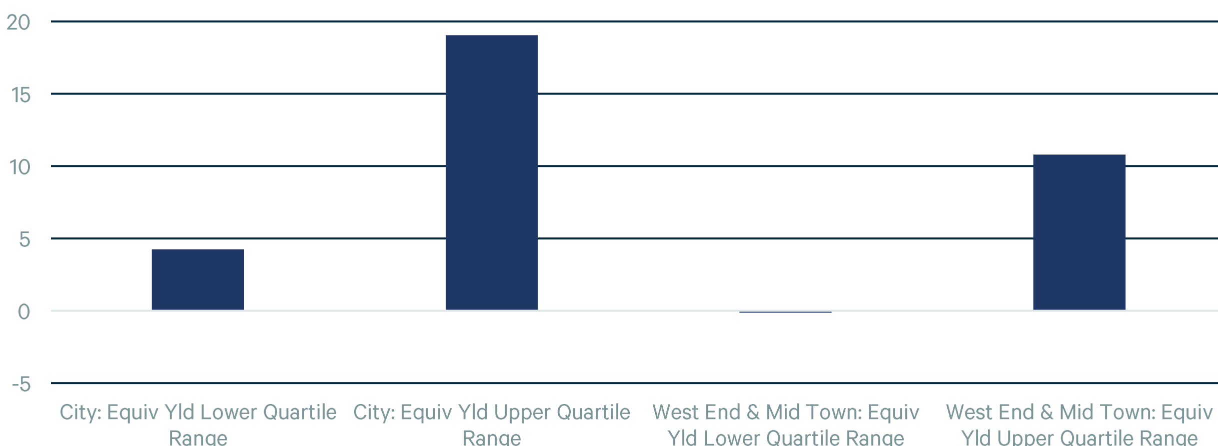
The central London office market has started to see a rebound in occupier demand after recording take up falling by almost half earlier in 2021, in the midst of a national lockdown and severe restrictions of movement. Take-up bounced back strongly in H2 2021, doubling from it's H1 level to 6.1 million sq ft. Although tenant demand and enquiries are ticking up again, occupiers are taking longer to decide as they wait for new working practices to get bedded in.

Both the de-densification of the office post-COVID and the growth in office related employment (forecast to grow at 1.2% p.a. in London over the next decade) will partially offset the drop in occupier demand from hybrid working. That said, we expect to continue to see, what has been an emerging trend so far, that new demand will be even more concentrated on the best buildings.

Strong evidence of a market bifurcation for London offices

In Central London, the vacancy rate remains elevated at just over 9%, more than double its pre-pandemic rate of 3.9%. Within the sub-markets, the vacancy rate varies significantly, with City and the Docklands seeing vacancy rates above 12% for the first time since 2004/05, whilst in the West End vacancy remains below 6%. Using the MSCI equivalent yield quartiles data as a proxy for prime* (lower quartile) and secondary assets (upper quartile), we can see a significant divergence over the past 12 to 18 months (chart 4). Vacancy rates in the prime part of the market have remained broadly unchanged over the course of the pandemic, whilst the secondary part has seen the vacancy rate double in both the City and West End. This indicates that the best space has proved most resilient through the last 12-18 months.

Chart 4 – Absolute change in vacancy rate by equivalent yield quartile (%) Q4 2019 – Q4 2021



Source: MSCI.

Coupled with the recorded rise in prime rents in certain sub-markets (an increase of 18% over the past 12 months in the West End), this highlights one of the key trends that we suspect will accelerate in the coming years, namely the bifurcation of the office sector. The number of leasing deals done in Central London above the prevailing prime rent has averaged 15% in 2021, a decade high and up from 5% in 2011 (chart 5). The increased focus in best in class can be seen from investors as well, with prime yields in both the City and West End compressing by 25 bps in H2 2021.

*Prime office assets or Grade A in EMEA is classified as an office unit of standard size commensurate with demand in each location, typically 1,000 sqm, an office unit of highest quality and specification within the local market and an office unit within the prime location (CBD, for example) of a market.

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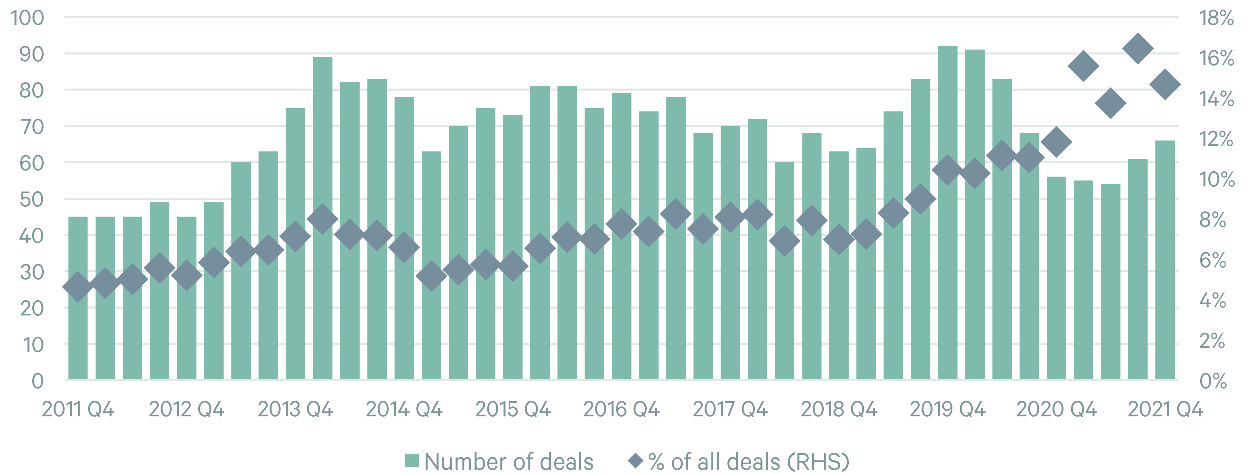
Chart 5 – Deals at Rent Over the Prevailing Prime Rent (over 2,500 sq. ft)



Source: CBRE.

ESG to be a main driver of the divergence between prime and average stock

We see two main drivers of why the divergence in performance between prime and secondary office assets will be sustained over the coming years. Firstly, the roadmap laid out by the government on the required minimum EPC rating buildings will require over the coming decades has focused investors mind on the cost and complexity to reposition non-compliant buildings. The government has proposed a minimum EPC rating of C by 2027 and B by 2030, which will require significant CAPEX for the majority of landlords as currently less than a fifth of buildings in the City have an EPC rating of A or B. Secondly, we are also seeing a change in what occupier's demand in terms of wellness and ESG characteristics of buildings. The pandemic has proved a catalyst for permanently higher tenant expectations. Robust air ventilation systems, well lit, amenitised offices that meet corporate occupiers' ESG goals have gained increasing importance to tenants.

Outlook

The best space has proved most resilient over the past 12 -18 months, and as demand returns it will be more focused than ever on the best buildings, with implications for market monitoring. Our office forecasts indicate a sustained divergence between best-in-class assets and average quality offices that will require significant CAPEX to reposition for future use. With City and West End prime offices returning a rental growth of 2.0% p.a. respectively over 2022-26 in comparison with average quality stock at 1.1% p.a. for the City and 1.4% p.a. for the West End.

Case Study: 120 Bishopsgate

Summary: Acquisition of a vacant possession office building allowing for an immediate repositioning to Grade A. Frontage onto both Bishopsgate, one of the City's principle throughfares, and Spitalfields. Multi-tenanted, with lease lengths ranging from 7-15 years.

Grade A with a complete refurbishment, delivering tailor made floors, tenant balconies, rooftop terrace, wellness suite and cycle-in facilities.

ESG Objectives: BREEAM Outstanding, Well Platinum, CycleScore Platinum and WiredScore Platinum accreditations on-track to being achieved.

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Paris

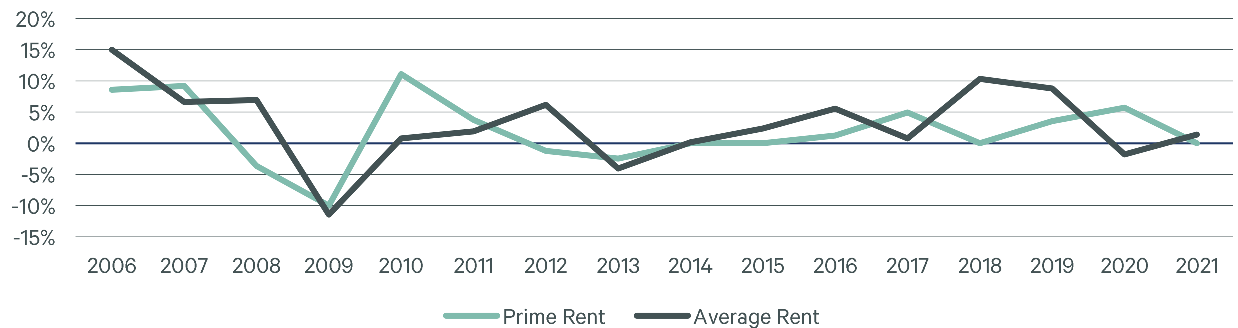
Paris shows resilience as the most liquid market in Europe

Paris is the largest office market in continental Europe. During 2020, it managed to keep its position as the most liquid in Europe due to the diverse depth of active investors, this has also been the case in 2021 according to Real Capital Analytics. Despite decreased demand, headline rents in the Paris region remain resilient and continue to rise in attractive areas. Although rents are proving resilient, owner incentives continue to increase. On average, incentives in the Paris region now represent 20.8% of headline rent for transactions >1,000sqm.

Newer, prime quality assets to generate solid rents compared to secondary stock

Take-up in the Paris office market plummeted at the start of the pandemic but since then seen a recovery. End of 2020 saw a significant improvement in take-up which has continued during 2021 as well. Although, it is only in the third quarter the market saw net absorption returning to positive levels. As a result, the Paris office market has seen rents stabilise after declines in 2020. However, there has been a difference depending on stock quality, indicating more resilience for Grade A* supply. Data shows a 6% y/y increase in prime rents in 2020 while average rents decreased when the effects of the pandemic was felt the hardest (chart 6). This has then evened out over 2021, with supply significantly decreasing, rents are also rising for renovated and even used space (average rents). That being said, it is important to acknowledge that there are sub-market differences within the wider Parisian office market.

Chart 6 – Rents (Y/Y% change) Paris CBD



Source: CBRE.

*Prime office assets or Grade A in EMEA is classified as an office unit of standard size commensurate with demand in each location, typically 1,000 sqm, an office unit of highest quality and specification within the local market and an office unit within the prime location (CBD, for example) of a market.

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Overall vacancy has skyrocketed during the pandemic in comparison to Grade A vacancy

After increasing throughout 2020 and in early 2021, the volume of vacant space stalled in the second half of 2021, totalling 4 million sqm. The geographical evolution of vacant space is twofold. On one hand, the supply has fallen in Paris city, yet on the other, it has increased throughout the rest of the Paris region. New/refurbished space represents almost on third of vacant space, which is high compared to previous levels, which makes it possible to offer more quality space compared to the pre-pandemic period. It is important to note that Grade A supply is still a very small part of the market, with second-hand stock dominating the Paris office market. In addition, this quality vacant space is unevenly distributed with geographical discrepancies becoming more acute. In Paris CBD, vacant space has decreased further in Q4 2021, to a vacancy rate of 3.2%. Comparing to pre-pandemic levels, Grade A vacancy in Paris CBD is back to even lower levels (-31%) in comparison with overall vacancy in the wider Parisian market, which remain historically high at 136% above pre-pandemic levels (chart 7).

Chart 7 - Vacancy Paris CBD (Q4 2019 – Q4 2021, % change)

Source: CBRE.

Outlook

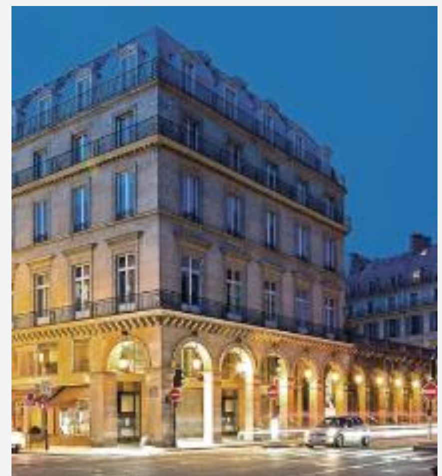
Overall, the crisis has highlighted occupiers' interest in high quality assets in strategic locations. Even though there is a high demand from tenants in Paris on outdoor spaces (which is ESG beneficial), market insights tell us the push for ESG compliant buildings is more investor led rather than tenant led currently. In addition, evidence from the investment market shows even stronger signs of recovery with prime yields compressing at the start of 2021, reaching historically low levels (2.6% in Q4 2021 compared to 2.75% in Q1 2020). The outlook for Paris CBD prime offices is strong, we forecasts Paris CBD rents to increase by 1.6% p.a. through 2022-26, in line with the European city average.

Case Study: Marengo

Summary: A comprehensive repositioning to Core in the centre of Paris. Excellent micro-location, in the direct vicinity of Le Louvres. The building provides offices with ground floor retail and a monumental atrium providing a typical flagship type building feature.

Business Plan: Re-position the office component to the highest standard, capitalize ERV growth and secure top market rent. Heavy refurbishment between 2016-2018. Successful leasing, well ahead of completion. New sub-market top rent at the time of leasing.

ESG Objectives: HQE conception and construction level Excellent achieved with the heavy refurbishment and a BREEAM in use certification is ongoing (targeted score at least Very Good).



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New York

Within six quarters, 6 ½ years of absorbed space evaporated

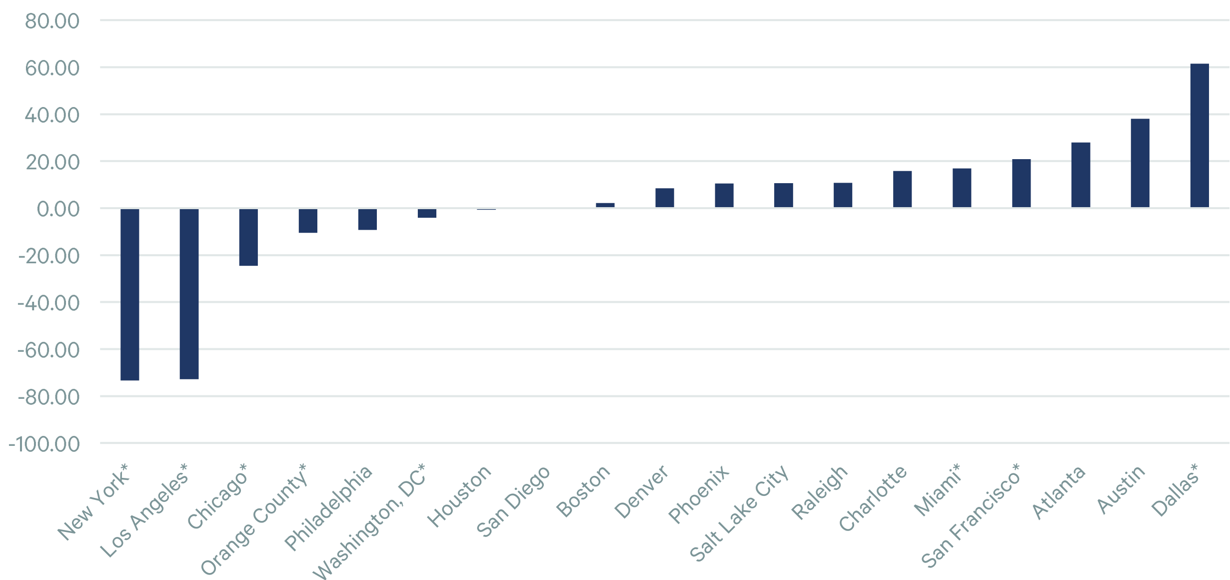
As the largest office market in the U.S. with more than 415 million sq. ft. of rentable space according to CBRE EA, it should come as no surprise that COVID's impact on the Manhattan real estate market was sharp and swift. In the span of just six quarters, the 20 million sq. ft. of office space that had been absorbed over the 6 ½ year period from Q4 2013 through Q1 2020 evaporated, bringing the city's overall office vacancy rate from 7.4% to 12.8%, levels not observed since the late 1990s. Including the additional amount of space available (whether or not vacant) paints an even dimmer picture of demand. Q4 2021's availability rate stood at 18.3%, a shade below Q2 2021's 18.5% figure, and the highest level since the mid-1990s.

Latest data suggest the end of space shedding and a path to recovery

Following the market's first full quarter of positive net absorption since the pandemic began in the third quarter, suggesting that the pace of space shedding may finally have peaked, the market recorded another negative quarter of net absorption, totalling -2.6 million sq. ft. of net absorption in Q4 2021 . Despite expected volatility going forward, the market appears to be on the mend, as indicated by the slowing pace of additions to sublease supply. Kastle Building Systems, which tracks occupancy by electronic key card and other secure methods of entry, reported that occupancy in New York's office buildings in early December 2021 reached 37%, the highest occupancy rate since March 2020.

Nonetheless, Manhattan lags many other metros in terms of the degree of office job recovery (chart 8). Even away from sectors like leisure and hospitality (where metro jobs stand 30% below pre-COVID levels), the recovery in office headcount has been sluggish at best.

Chart 8 – Total Change in Office-Using Employment (December 2021 vs. December 2019)



***Metropolitan area**

Sources: BLS, Moody's Analytics.

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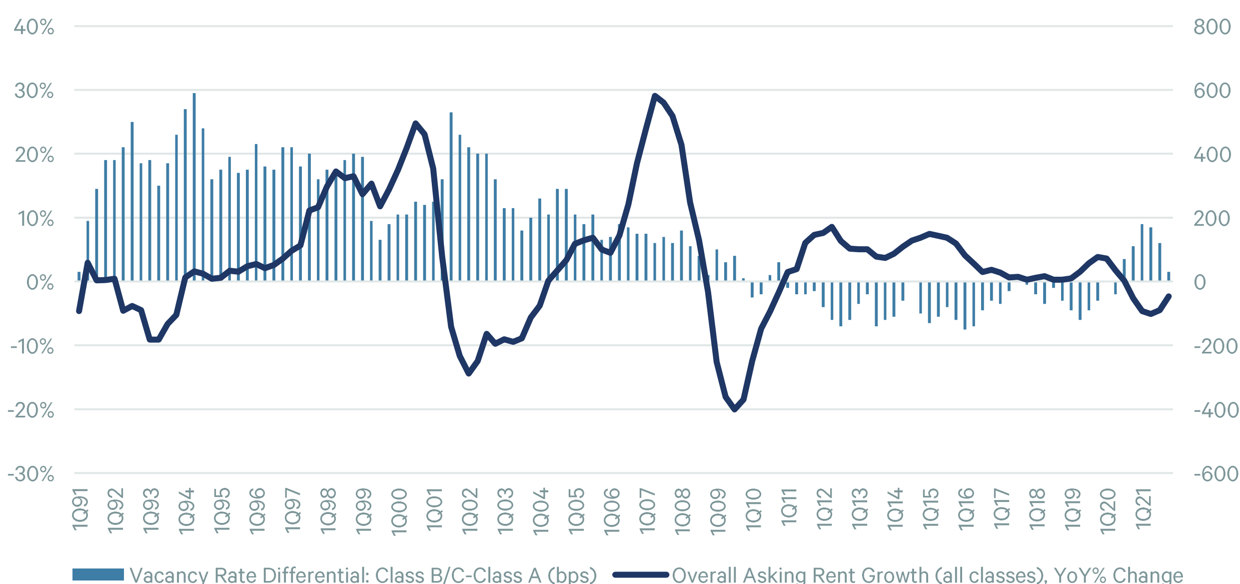
The city has a long way to go in order to recoup the space shed during the COVID recession. (Data from CoStar may serve as a somewhat dire reminder of just how long the recovery may take, Manhattan occupied space peaked in Q2 2000, and has never returned to prior levels). As with prior recoveries, we expect that the rebound will favour Class A assets in highly-amenitised buildings. During periods of economic instability, tenants have shown a willingness to shed space in lower-quality buildings and use the ensuing decline in overall rents as an opportunity to upgrade their space as improving economic conditions warrant (chart 9), and we expect that a similar trend will persist this cycle. However, with a sizable supply pipeline (another 11 million sq. ft. of new office product is set to deliver, and roughly 40% of the total amount remains unleased), vacancies could remain elevated for all classes of product for the next several years.

Chart 9 - Manhattan Vacancy Rate by Class, % and Differential, pp. YoY % Change in Manhattan Asking Rents and Vacancy Rate Differential, pp



Source: CBRE EA.

Outlook

Landlords recognise that the hybrid work environment is likely here to stay and must now compete for employees' attention. The leasing decision is no longer a choice between Office A and Office B, but between office and home, particularly as improved technology and increased data access speeds make the need to be in the physical office less clear. Best-in-class buildings will be those with serviced offerings that make employees feel supported and well-cared for. Whether it is offering complimentary concierge services to facilitate meal delivery and complete food shopping, providing electric vehicle charging stations, incorporating child-care services and company-run health clinics on-site, landlords will have to redefine those features that define the resilient, and occupied, office of tomorrow. So, what makes a best-in-class asset? Amenitised space still reigns supreme, but the definition of must-have amenities has changed. Instead of communal gyms, cafes, and cocktail hours, the focus for many tenants has turned to health and wellness. In the process, features such as outdoor spaces that function as places to work and socialize have become paramount. Equally important are buildings with superior ventilation systems, which are frequently those built to LEED gold or silver standards.

The outlook for New York Manhattan prime offices is better than our American city average. According to our latest forecasts, we expect New York Manhattan rents to increase by 2.8% p.a. through 2022-26, compared to the American average of 2.2% p.a.

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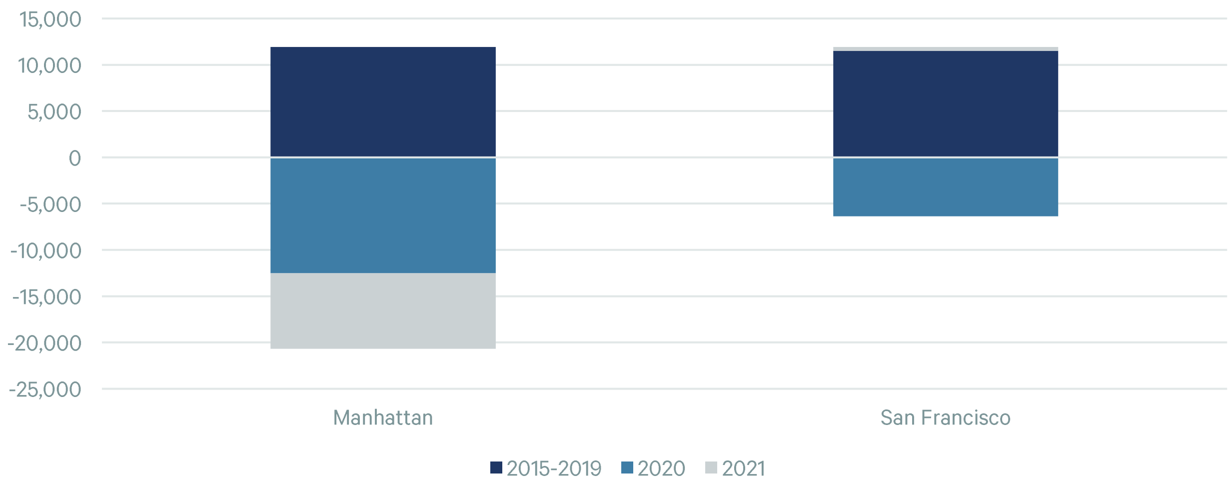
San Francisco

Net absorption relatively resilient compared to its gateway peer New York

San Francisco, like New York City, was similarly devastated by COVID. While the cumulative increase in net absorption in the five years leading up to COVID was similar in the two cities, the subsequent decline in 2020 and beyond was smaller in San Francisco (chart 10).

Chart 10 – Cumulative Office Net Absorption Comparison (000s SF)



Source: CBRE EA.

Even so, because the San Francisco office market is less than one-quarter the size of the Manhattan office market by square footage, the COVID-induced decline was dramatic enough to send the vacancy rate, which had dropped to just 5.2% at the end of 2019, to 15.1% by Q4 2021 (and to 19.4% for Class B/C product). However, the subsequent labour market recovery has been more rapid in San Francisco than in New York, for example (chart 11), which has helped to boost net absorption into positive territory for the last two quarters. Office-using jobs now stand 3.7% higher in the San Francisco Metropolitan Division (December 2021 vs. February 2020), versus 4.1% lower in the New York metro and 1.3% for the U.S. as whole.

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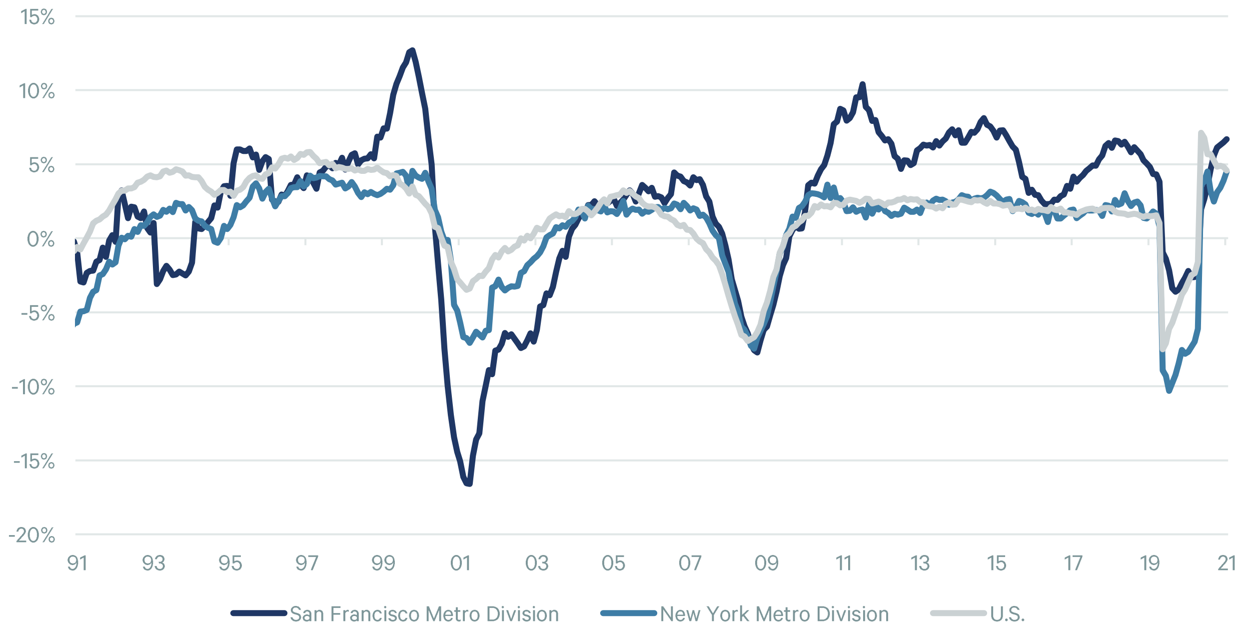
Chart 11 - Office Employment (YoY%) Change: Geographic Comparison



Sources: BLS, Moody's Analytics.

Notable shift in performance in relation to its neighbour San Jose

Despite the notable gains in employment, net absorption in 2021 was broadly flat for San Francisco, with just 418,000 sq. ft. of positive net absorption for the year, following -6.3 million sq. ft. of negative net absorption in 2020. The office market's recovery continues to lag the recovery in a number of high-growth, secondary office markets, namely Austin, Salt Lake City, Raleigh and in California, San Diego and San Jose. The disparity in performance between San Francisco and San Jose, in particular, is notable. San Jose's vacancy rate has consistently averaged more than 5 percentage points above San Francisco's vacancy rate, but as of Q4 2021, San Jose's vacancy rate is more than a point below San Francisco's vacancy rate. Both areas have an above-average concentration of STEM-related jobs (suggesting an equal opportunity for employees to work from home) and both metros have seen a roughly equal increase in the stock of office space over the last four quarters, with San Jose's stock increasing by 5.4% in sq. ft. terms versus a 4.3% increase for San Francisco.

Outlook

Even with lacklustre leasing velocity, there are still signs of investor optimism. Office sales in San Francisco as a percentage of total U.S. office sales by dollar volume stood at 4.2% in 2021. After a pause in new construction deliveries in 2020, known projects that have broken ground are set to deliver 2.4 million sq. ft. of new office space beginning in 2022 and beyond, 36% of which remains unleased. The outlook for San Francisco prime offices is better than our American city average. We forecast San Francisco rents to increase by 2.8% p.a. through 2022-26, compared to the American average of 2.2% p.a.

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Sydney

Sydney's physical office occupancy experiencing volatility due to COVID measures

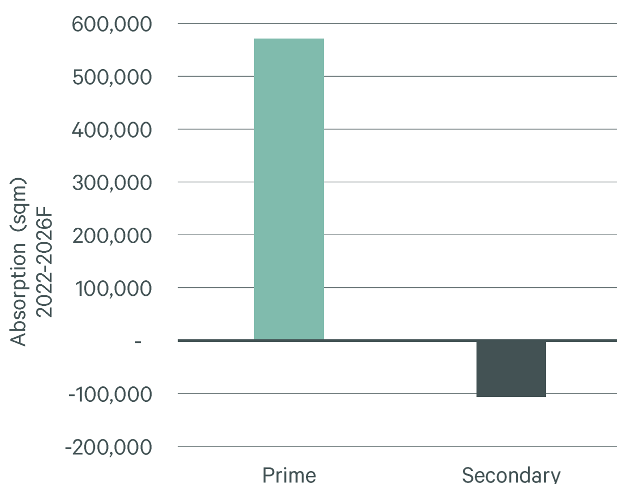
Sydney is Australia's largest city and office market, with a population of 5.4 million and office stock of 8.1 million sqm across the metropolitan area (Oxford Economics, CBRE). Sydney workers began returning to the office in the second half of 2020, with office physical occupancy* up to 45%, by December 2020 and even reaching 68% in May 2021 before the Delta variant plunged Sydney into a nearly four-month lockdown beginning in June 2021. Office physical occupancy plummeted to 4% by September 2021, but then increased to 23% in November 2021, after Sydney emerged from lockdown in October 2021. However, a December 2021 spike in cases is likely to delay a more substantial return to the office. Office physical occupancy in Sydney was just 7% in January 2022.

A clear trend that has emerged from the pandemic is the bifurcation in the office market between prime** and secondary product. Reduced effective rents and a flight to quality trend have increased demand for prime office. For example, prime office absorption in the Sydney CBD was -36,911 sqm in 2020, compared to a much steeper decline of -73,435 sqm for the secondary segment. During H1 2021, absorption turned positive, with prime office posting 20,586 sqm of absorption, compared to just 6,683 sqm for secondary office. Absorption in H2 2021 turned negative, due to Sydney's four-month lockdown beginning in June 2021, but prime office posted a smaller decline of -25,456 sqm, compared to -57,176 sqm for secondary office.

In addition to absorption, there is a clear difference in vacancy between prime and secondary office, especially when considering the forecast for the next few years. Due to the pandemic, the Sydney CBD prime office vacancy rate increased from 3.0% in December 2019 to 8.9% in December 2021, while the secondary office vacancy rate increased from 5.4% in December 2019 to 12.1% in December 2021.

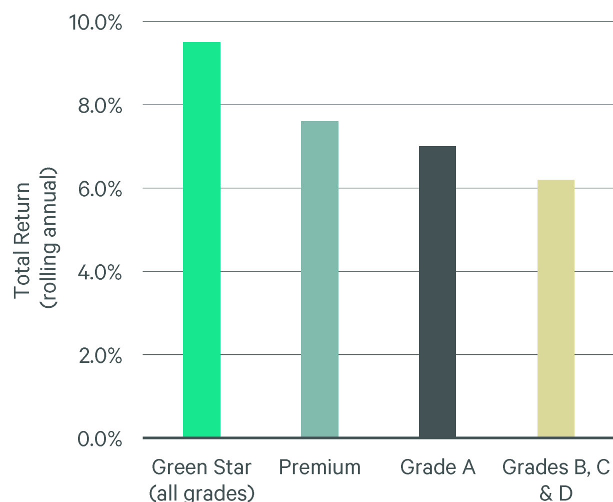
The current (Q4 2021) premium for prime net effective rents, relative to secondary net effective rents is 36.3% (CBRE). Prime net effective rents fell 15.9% in 2020, compared to a 14.0% fall for secondary office. As of Q4 2021, both prime and secondary net effective rents fell 6.5% y/y (CBRE).

Chart 12 - Sydney CBD Office Absorption: Prime and Secondary Forecasts (2022-2026)



Source: CBRE.

Chart 13 - Sydney CBD Office Total Returns: (rolling annual as of Q3 2021)



Source: MSCI.

*"Physical occupancy" represents the percent of office workers physically in the office, compared to pre-COVID levels, based on a Property Council of Australia (PCA) survey.
** Within Australia, building grades are defined by the Property Council of Australia. Prime office in Australia represents both "Premium" and "Grade A" office buildings. Both are considered prime if containing high quality amenities, but Premium office also needs to be a trendsetter in establishing rents. From an ESG perspective, Premium office requires a 6-star Green Star rating and a NABERS energy 5.5-star rating, while Grade A office requires a 5-star Green Star rating and a NABERS energy 5.5-star rating. A modern office building would have a Premium or Grade A classification.

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The high-ESG segment has seen the highest annual total return in Q3 2021

According to MSCI, Premium and Grade A Sydney CBD office total returns were stronger than the Grade B, C & D office segment, with Premium office posting a 7.6% rolling annual total return as of September 2021, compared to 7.0% for Grade A and 6.2% for Grade B, C & D combined. Interestingly, the high-ESG segment, known as Green Star, posted the highest rolling annual total return of 9.5% within the Sydney CBD office market, as of September 2021 (chart 13).

Outlook

Leasing sentiment and strong transaction volume in 2021 demonstrate resilience in the Sydney office market, despite the nearly four-month lockdown. In 2021, leasing enquiry volumes were at their highest level recorded since 2014 and a total of 543 briefs were received. Although Sydney's sublease availability increased 10.7% q/q in Q4 2021 to approximately 98,000 sqm, it is still well below the prior peak of 170,751 sqm in November 2020. In its Q3 Australia Office publication, CBRE reports that prime CBD office assets were popular among investors, indicating confidence in the office sector outlook. In Q4 2021, Sydney accounted for three-quarters of total office transaction volume in Australia, according to CBRE.

As a result of the pandemic, there is an increased focus on wellness, flexibility and high-quality amenities to attract workers back to the office. Post-pandemic, there is an opportunity to focus on "future-proofed" office buildings that adopt emerging workplace trends. According to our latest H2 2021 base case forecasts, Sydney CBD prime net effective rents are projected to turn positive in 2022 and average growth of 4.6% per annum over 2022-2026.

Case Study: 118 Mount Street

Summary: Constructed in 2020, the building is a 20,405 sqm Grade A office located in North Sydney.

Investment Strategy: The investment strategy focused on developing a brand-new high-quality office building, with strong leasing fundamentals. Despite the pandemic and lockdowns, which severely limited the ability to market the property, strong leasing was achieved. There is a clear flight to quality by tenants who are looking for new buildings with high ESG credentials.

ESG Objectives: The building has a 5-star "design and as built" Green Star rating by the Green Building Council of Australia and a 5-star NABERS energy rating. All leases contain Green components to ensure tenants abide with ESG initiatives implemented in the building.

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Tokyo

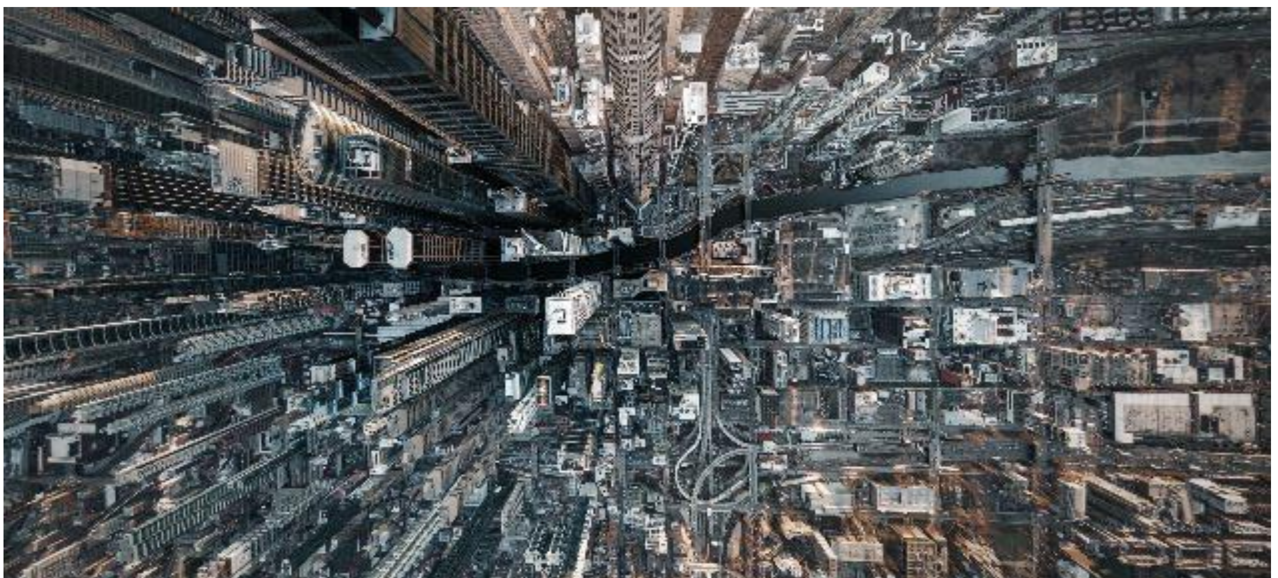
After four national states of emergency, employees more likely to return to the office

Tokyo is Japan's largest city with a population of 14.1 million across the prefecture and office stock of 20.5 million sqm within Tokyo's central five wards (Statistic Bureau of Japan and CBRE CREIS). Since the onset of the pandemic, Japan declared a "state of emergency" four times, with the last state of emergency lifted in late September 2021. Rather than enforce strict lockdowns, Japan encouraged people to avoid unnecessary gatherings and crowded places. Most Tokyo office workers adopted remote working during the pandemic. However, many companies plan to reduce the amount of remote working, once health concerns from the pandemic decrease (Xymax Survey, August 2021). According to the CBRE Japan November 2021 Future of Office Report, companies in Asia Pacific prefer office-based working to a greater extent than those in Europe and the U.S., with 80% of respondents indicating a preference for their employees to return to the office. However, 47% of respondents would allow their employees to work from home if they wish.

Both net absorption and vacancy indicate discrepancies between Grade A and Grade B space...

Within Japan, office quality is segmented by Grade A*, Grade A- and Grade B. Since the onset of the pandemic, there has been a clear difference in the performance between Grade A and Grade B office assets within Tokyo's central five wards. For example, Grade A net absorption was 529,289 sqm in 2020, compared to -20,872 sqm for Grade B office (CBRE CREIS). In 2021, Grade A office posted 92,568 sqm of net absorption, compared to -42,955 sqm for the Grade B segment office (chart 14).

Similarly, there has also been a clear difference between Grade A and Grade B office vacancy. Since the onset of the pandemic, the vacancy rate has increased more for Grade B office, compared to Grade A. The vacancy rate increased 330 bps for Grade B office from 0.4% in Q4 2019 to 3.7% in Q4 2021, while the vacancy rate for Grade A office increased by 200 bps from 0.5% in Q4 2019 to 2.5% in Q4 2021 (chart 15). Secondary vacancy is expected to soften further in the Grade B segment, as some tenants take advantage of lower Grade A rents and move to Grade A office buildings, which have become more affordable during the pandemic.



*A prime office building in Tokyo would be considered Grade A and have the following specifications: 1) located within Tokyo's central five wards, 2) gross floor area of 33,000 sqm (10,000 tsubo) or greater, 3) net leasable area of 21,000 sqm (6,500 tsubo) or greater, 4) floor plate of 1,650 sqm (500 tsubo) or greater and 5) less than 15 years old. In addition, other factors such as landmark status would be considered to determine a Grade A classification as well. Also, due to Japan's propensity for earthquakes, the Building Standards Law was amended in 1981 to include stricter standards for earthquake resistance for all buildings.

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...rents are a different story

Interestingly, higher grade rents have been falling more than lower grade rents. Grade A office average achievable rents fell -3.0% in 2020, compared to a Grade B fall of -2.2% (CBRE CREIS). Rents continued to decline in 2021, with Grade A rents falling -6.0%, while Grade B rents declined -4.9% in 2021. The reason behind this is both due to the supply development pipeline and the rate of pre-leasing seen in the market.

In regard to supply, higher grade rents have been falling more than lower grade rents, as landlords aim to secure tenants prior to a significant amount of supply coming to market in 2023, according to CBRE. As the supply-demand balance is set to continue to weaken in the foreseeable future, rents are projected to undergo further declines. It is important to note that rent growth is also impacted by Tokyo's fixed-term leasing contracts for Grade A office buildings. These fixed-term leasing contracts are typically two years, thus leasing contracts signed in 2019 or early 2020 expire in 2021 and 2022, which is a much different economic environment. In regard to pre-leasing, which is dependent on the economic climate, many Grade A buildings were fully let upon completion just prior to the pandemic. However, in more challenging economic times, pre-leasing levels decline. Since the pandemic, the overall economic growth outlook has softened, and at the moment, occupiers/tenants still remain cautious about their business outlook and are thus contemplating office space requirements. As a result, for buildings delivered in 2021 and 2022, the pre-leasing rate has been lower, compared to pre-pandemic levels.

Chart 14 - Tokyo Office Net Absorption (2021): Grade A and Grade B

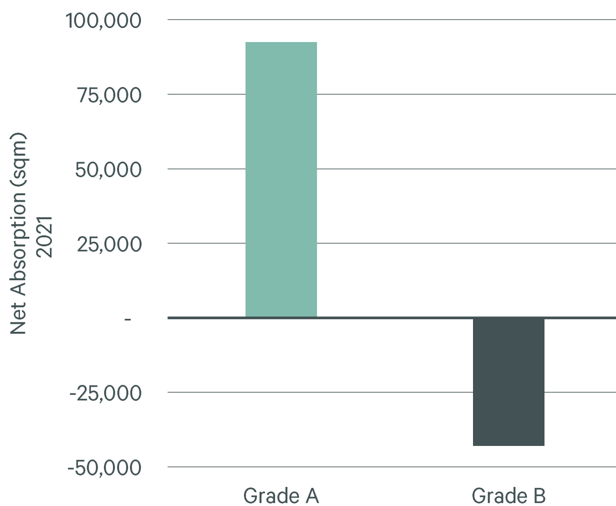
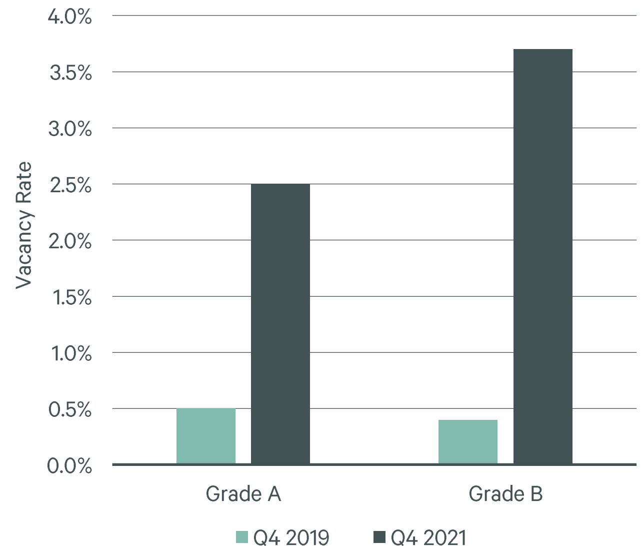


Chart 15 - Tokyo Office Vacancy Rate: Grade A and Grade B



Source: CBRE CREIS, Q4 2021 (Tokyo Central Five Wards).

Outlook

As Japanese companies tend to be more office-oriented, "future-proof" office attributes are more focused on transportation and safety features, rather than amenities to attract workers back into the office. Within the office itself, many Japanese occupiers plan to increase the amount of space for phone calls or web conferences, space for internal collaboration and space to co-work with other employees, according to the CBRE Japan 2021 Future of Office Report. According to our latest H2 2021 base case forecasts, Tokyo CBD office rents are projected to fall -0.5% in 2022, before turning positive in 2023 and averaging growth of 2.4% per annum over 2023-2026.

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APPENDIX - Global ESG Classifications for Real Estate

LEED – US

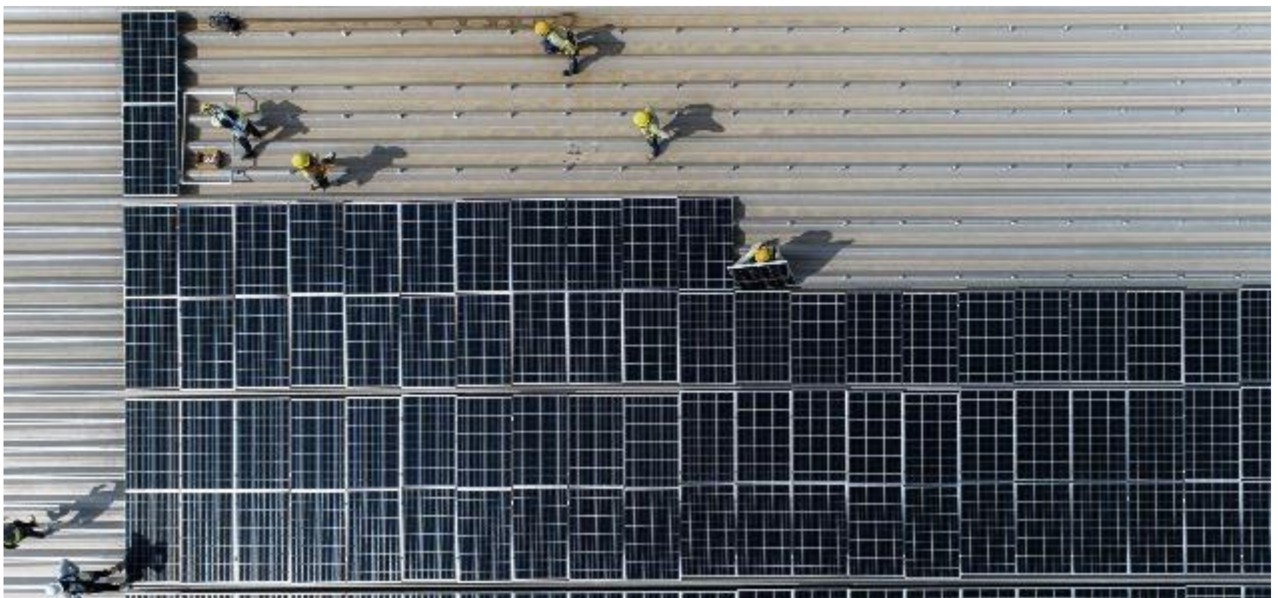
LEED (Leadership in Energy and Environmental Design) is the most widely used green building rating system in the world. Available for virtually all building types, LEED provides a framework for healthy, highly efficient, and cost-saving green buildings. LEED certification is a globally recognized symbol of sustainability achievement and leadership. Developed by the non-profit U.S. Green Building Council (USGBC), it includes a set of rating systems for the design, construction, operation, and maintenance of green buildings, homes, and neighborhoods, which aims to help building owners and operators be environmentally responsible and use resources efficiently.

BREEAM – Europe

BREEAM (Building Research Establishment Environmental Assessment Method), first published by the Building Research Establishment (BRE) in 1990, is the world's longest established method of assessing, rating, and certifying the sustainability of buildings and infrastructure. It recognizes and reflects the value in higher performing assets across the built environment lifecycle, from new construction to in-use and refurbishment. BREEAM does this through third party certification of the assessment of an asset’s environmental, social and economic sustainability performance, using standards developed by BRE. This means BREEAM rated developments are more sustainable environments that enhance the well-being of the people who live and work in them, help protect natural resources and make for more attractive property investments.

HQE – France

HQE Certification is a standard for green buildings in France, based on the principles of sustainable development first set out at the 1992 Earth Summit. The standard is controlled by the Paris-based Association pour la Haute Qualité Environnementale. HQE is the French certification awarded to building construction and management as well as urban planning projects. HQE promotes best practices, sustainable quality in building projects and offers expert guidance throughout the lifetime of the project. The standard specifies various criteria around mainly managing the impacts on the outdoor environment (minimizing energy use, minimizing building maintenance and repair, harmonious relationship between buildings and their immediate environment etc.) and creating a pleasant environment (air quality controls, visual attractiveness, acoustic controls etc.).



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CASBEE/DBJ Green Building Certification – Japan

Comprehensive Assessment System for Built Environment Efficiency (CASBEE) is a method for evaluating and rating the environmental performance of buildings and the built environment. CASBEE was developed by a research committee established in 2001 through the collaboration of academia, industry and national and local governments, which established the Japan Sustainable Building Consortium (JSBC) under the auspice of the Ministry of Land, Infrastructure, Transport and Tourism (MLIT). CASBEE has been designed to both enhance the quality of people's lives and to reduce the life-cycle resource use and environmental loads associated with the built environment, from a single home to a whole city. Consequently, various CASBEE schemes are now deployed all over Japan and supported by national and local governments.

The Development Bank of Japan "DBJ" Green Building Certification program is one of the main green sustainability rating programs for office buildings in Japan. The DBJ Green Building Certification program was established in 2011 "for the purpose of supporting properties that give proper care to the environment and society". DBJ Green Building certifications are conducted by the Japan Real Estate Institute (JREI) and the program applies to properties, "which are owned or operated by clients and business partners of DBJ and/or JREI". A modern office building in Japan would typically have a CASBEE certification and/or a DBJ Green Building Certification (if applicable).

NABERS/Green Star – Australia

NABERS and Green Star are the two main sustainability rating systems for office buildings in Australia.

Launched in 1988, the National Australian Built Environment Rating System (NABERS) rating system focuses on the ongoing operational efficiency of a building. NABERS provides a building rating from one to six stars for efficiency across: energy, water, waste and indoor environment, with four stars representing "good" and six stars representing "best practice".

Launched in 2003 by the Green Building Council of Australia, Green Star is a comprehensive rating system that assesses the sustainability of the design and construction of new buildings or major refurbishments under the "buildings" and "design and as built" categories. Green Star provides a building rating from one to six stars, with four stars representing "best practice" and six stars representing "world leadership".

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