Offices: everybody’s talking but nobody is investing

The Q4 Global Real Estate Fund Index (GREFI) indicates that the fall in performance that first became noticeable in Q3 steepened in Q4, at least in Europe and the US if not in Asia Pacific (see Figure 1). Concerns have crystallised around the outlook for offices and the problems for the sector are aggravated by rising interest rates and banking failures in the first half of 2023.

The superior performance of Asia Pacific reflects a slower response to changing global market conditions in the form of higher inflation, rising base rates and slower economic growth. China is currently less connected to the economic cycle prevailing in the rest of the world because of its use of lockdowns long after they had been abandoned elsewhere. Lower inflation has allowed the People’s Bank of China to support growth and the Bank of Japan has continued its ultra-loose monetary policy stance. Australia and Korea, however, are suffering from the high inflation and interest rates prevailing across the rest of the developed world.

Offices remain under pressure. NCREIF reported that valuations of US offices fell -5.86% in Q4 last year. In Europe, INREV’s Office Fund Index reported a negative capital growth in Q4 2022 of -3.8%. ANREV’s Office Fund Index, largely focused on Australia, recorded returns of -1.5% while the performance of all funds in Asia Pacific improved to 1.5% for Core and 4.2% for Non-Core funds.

Remote and hybrid models of work are a threat to the viability of established office markets causing rising vacancy rates and consequently falling rents (see Figure 2). Demand for Grade A space offering environmentally efficient space remains strong and such buildings are achieving premium rents. However, secondary assets are in danger of becoming obsolete and often require major capital expenditure.

There are a series of common characteristics for buildings that are responsible for the most vacant space since the pandemic. CBRE has labelled them “hardest hit buildings”. These buildings are most commonly located in the Pacific and Northeast downtown markets of the US with higher crime rates and fewer external amenities including bars, cafes, restaurants and theatres. The environment compares poorly with Paris’ Triangle d’Or or London’s West End. It also creates barriers to change of use to residential and in some cases the buildings’ footprint and office floor depth makes such conversion impractical.

There is no single solution to the office sector’s malaise, as regions and countries move in a different way. A general move back to the office will help. BlackRock announced this month that employees are required to work in the office at least four days a week. Otherwise, the focus on green, energy efficient buildings means that older stock will need to be retrofitted or converted if possible.

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Figure 1: Global Real Estate Fund Index (GREFI): local currency total returns (%)

<table>
<thead>
<tr>
<th>Europe</th>
<th>Asia Pacific</th>
<th>USA</th>
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<tbody>
<tr>
<td>4%</td>
<td>-5%</td>
<td>-8%</td>
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Source: ANREV / INREV / NCREIF Global Real Estate Funds Index (GREFI)

Figure 2: Global city office vacancy rates (%)

<table>
<thead>
<tr>
<th>Europe</th>
<th>Asia Pacific</th>
<th>USA</th>
</tr>
</thead>
<tbody>
<tr>
<td>0%</td>
<td>5%</td>
<td>10%</td>
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Source: Europe and Asia Pacific, CBRE Research | U.S., CBRE Econometric Advisors | Q1 2023.*

*Australia Markets are for CBD only as at Q4 2022. All others are total market vacancy rates.
Asia Pacific investors become main source of newly available global capital

- Global strategies grow in demand
- European investors lose dominance
- Allocations to separate accounts and joint ventures increase
- Residential and industrial/logistics remain preferred sectors in Europe

In 2022, fund managers raised a minimum of €246 billion or $264 billion of new capital for non-listed global real estate. However, capital raised across Europe, Asia Pacific, and North America was lower than in 2021 although broadly consistent with long-term annual averages. Vehicles with global strategies were the only category to see a year-on-year increase in capital raised, up by €8 billion to €64 billion or $68 billion.

Asia Pacific investors became the primary source of capital for real estate globally for the first time in the history of the survey, contributing 35% of the capital raised in 2022. European investors raised a further 30% and North American investors contributed 34%.

For the first time in the history of the survey, insurance companies and pension funds represent less than 50% of global capital contributions. Sovereign wealth funds and government institutions, the dominant Asia Pacific investors, now represent more than 15% of capital raised in 2022.

High market uncertainty and ongoing price discovery meant that only 26% of the total capital raised during 2022 has already been invested. Fund managers are ready to rapidly deploy this capital once the choppy market conditions described above stabilise.

For more information read INREV snapshot or ANREV snapshot.

Figure 3: Capital raised for investment in non-listed real estate by regional strategy

Global Research Committee’s view

Amid the lingering pressures on the global real estate market from 2022, distress in the banking sector, beginning in the U.S. and later in Europe, introduced additional volatility to the office sector in early 2023. These events have further tightened lending standards in most markets around the world, affecting debt originations in an already-challenged market. While rate hikes have impacted real estate lenders broadly, the onset of the banking failures has predominantly affected banks, who now face additional scrutiny from regulators about commercial real estate (CRE) exposure. These events may place strain on the real estate market if small and mid-sized banks pull back lending. However, the commercial real estate debt market is diverse. In the U.S., for example, large banks and various non-bank lenders such as mortgage REITs, life insurance companies, and private bridge lenders are alternative sources to fill a potential gap. That said, the tightening of lending standards has heightened focus on sponsor, sector and asset quality. Commercial real estate is an income-producing asset class which has generally held up well during uncertain economic times. Asset specific stress is to be expected, particularly within the evolving office market where contagion from declining values is a concern for the sector. But overall, weakness should be limited as abundant capital and solid pre-pandemic underwriting allows for extensions and creative restructuring. Looking forward, financing conditions may improve towards the end of the year as inflation is expected to fall further and the start of the interest rate unwinding cycle comes into sight.