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SPECIAL REPORT

Europe's return to the office will be robust but uneven

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EXECUTIVE SUMMARY

- Demand loss for the office sector was unprecedented in the wake of the COVID-19 pandemic. Yet, overall occupancy levels have not seen a precipitous decline due to reasonable supply and a nearly rock-bottom vacancy prior to the pandemic.
- Many European office markets were already familiar with flexible working arrangements, including work from home. As a result, most corporate occupiers were able to weather the impact of COVID-19 better than landlords in some other property types.
- Environmental, Social, and Governance (ESG) considerations were already gaining attention prior to the pandemic. The focus has heightened considerably over the past 18 months, however, with tenants looking closely at environmental considerations (air filtration, open spaces, and redesigned workstation layouts) and social and governance factors (equity of access and housing affordability).
- The return to office for Europe will vary greatly by region due to differences in industries, cultures, and degrees of urbanization. This unevenness will lead to challenges and opportunities that investors with feet on the ground should be aware of.
- For investors, we recommend a focus on newer built, high-quality assets that meet evolving tenant needs in markets with clear "DIGITAL"[1] drivers of demand. We would also recommend that investors pay particular attention to life science and medical office assets due to their growing importance in the new economy.

[1] DIGITAL refers to key long -term growth drivers centered around demographics, innovation, globalization, infrastructure, and technology that Principal has identified as metrics of long-term market outperformance.

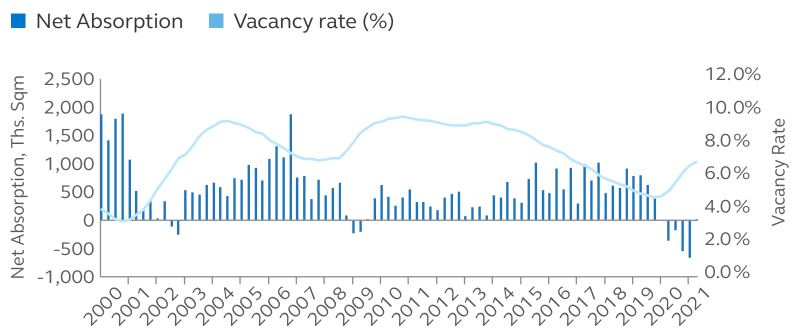
Like other economies, Europe resorted to drastic pandemic-mitigation measures, which included the near total shut down of urban transportation networks, deeply impacting the physical occupancy of office space. Normally vibrant office markets lay silent as the continent made an unprecedented pivot to remote work. After a slow start to vaccinations in the spring, Europe has caught up, allowing an increasing number of markets to reopen offices. The path forward will be far from linear, however, since households and employees need to feel comfortable with health and safety standards as they return to the office, especially with the new and potentially more contagious Omicron variant of COVID-19 prevalent. The experience of remote work on an unprecedented scale also complicates the equation for investors. Moving forward, the impact of remote work on demand will be nuanced by industry, region, and urbanization. To navigate the investment opportunities in this sector, we analyze some key trends to identify the characteristics we recommend and seek in office investment markets.

The pandemic created unprecedented demand loss

In a seemingly overnight upheaval, nearly all office workers found themselves forgoing their daily commutes to work from home (WFH). This drastic shift, mandated by strict lockdowns, led to unprecedented declines in demand for the office sector across the region. These declines were significantly more severe than prior economic recessions and, as shown in Exhibit 1 below, negative net absorption as a result of the COVID-19 pandemic was nearly four times greater than during the Global Financial Crisis (GFC). Despite the massive drop in demand, vacancy rates stayed more resilient than during both the GFC and dot-com bubble in the early 2000's. In fact, the current vacancy rate of 7% is still below the pre-GFC low of 7.1% and still falls within equilibrium (~8%). The primary reason is the lack of new supply during this cycle that has allowed market fundamentals to remain healthy and yields tight.

EXHIBIT 1: Vacancies did not skyrocket despite unprecedented demand loss

European demand and vacancy



Source: CBRE-ERIX, Q2 2021

*Europe is defined as an aggregation of Vienna, Brussels, Prague, Copenhagen, Paris, Berlin, Frankfurt, Munich, Dublin, Amsterdam, Warsaw, Barcelona, Madrid, London-City and London-West End

An analysis of market data makes it clear that the brunt of the blow to demand was felt acutely in a handful of markets. London-City and the West End alone saw nearly 500,000 square meters of negative net absorption in 2020, representing 3% of their combined total stock. Similarly, markets like Dublin, Paris, and Lisbon also saw large declines in demand due to strict lockdowns. Amsterdam and Helsinki, however, had already established hybrid work schedules prior to the pandemic. As such, they saw minimal impact on aggregate demand when the pandemic disrupted typical work routines, particularly for prime assets in good locations.

Furthermore, many regional markets remained steadfast in the face of the pandemic because of trends identified by our DIGITAL strategy for structural growth drivers. Their recent growth and rising investor interest have further ignited discussions between gateway and regional markets. France is one such example, where Paris has seen slowing demographic trends due to declining affordability and shifting business mindsets. In contrast, smaller regional cities, such as Toulouse and Lyon, have seen robust take up and rapidly increasing investment volumes. This does not spell the end of gateway cities but does speak towards the capability of regional markets to fit into core, lower-risk portfolios which typically gravitate towards deeply established markets.

In addition to current pullbacks in demand, many large companies have put their future office plans on hold as they further evaluate their future demand for space. Corporate surveys suggest that many office workers may work remotely one or two days each week in a hybrid work model, which may lead some firms to occupy less space going forward to maximize space efficiency. It may appear obvious that reorganizing office space would lower future growth for the entire sector, but this highlights the importance of selecting the right asset in markets to deliver outperformance.

Transactions continue, but asset quality is limited

Heightened uncertainty for future office demand had little impact on the transaction market for office investments at the start of the pandemic. Volumes were exceptionally resilient during the first half of 2020 before declining. In 2021, transactions have gained momentum, however, with investor optimism rising after successful vaccination programs across Europe. Although volumes are still below their pre-pandemic norms, pricing has remained strong with yields continuing to tighten. This has been largely driven by the flight to quality for investors which has led to further cap rate compression despite weaker space market fundamentals.

EXHIBIT 2: European office transactions have slowed, but high-quality remain active

	Transaction Volume, Bil.	YoY % Chg.	Total Square Metres, ths.	Price per sqm	Cap Rate, trailing 12-month avg.	Shift, Bps
2019	136.25 €		33,078	4,119 €	5.6%	
2020	96.12 €	-29.5%	22,938	4,191 €	5.3%	-23
2021 YTD	59.68 €	-8.8%	15,523	3,845 €	5.2%	-14

Source: RCA, Q3 2021

The concentration on high-quality assets had already begun prior the pandemic, however. Yet the further price gap for well-located assets, alongside weaker fundamentals, suggests that investors view this as a differentiator for future demand to the sector. Major cities, such as Frankfurt, London, and Paris have also seen strong investment volumes despite stricter lockdowns in dense urban areas. This has likely been due to their abundance of high-quality assets while owners of lower-quality assets have held off until the dust settles. However, life sciences and medical offices are the outlier within the office sector. Their demand has remained resilient and investor appetite has been insatiable even prior to the effects of the pandemic.

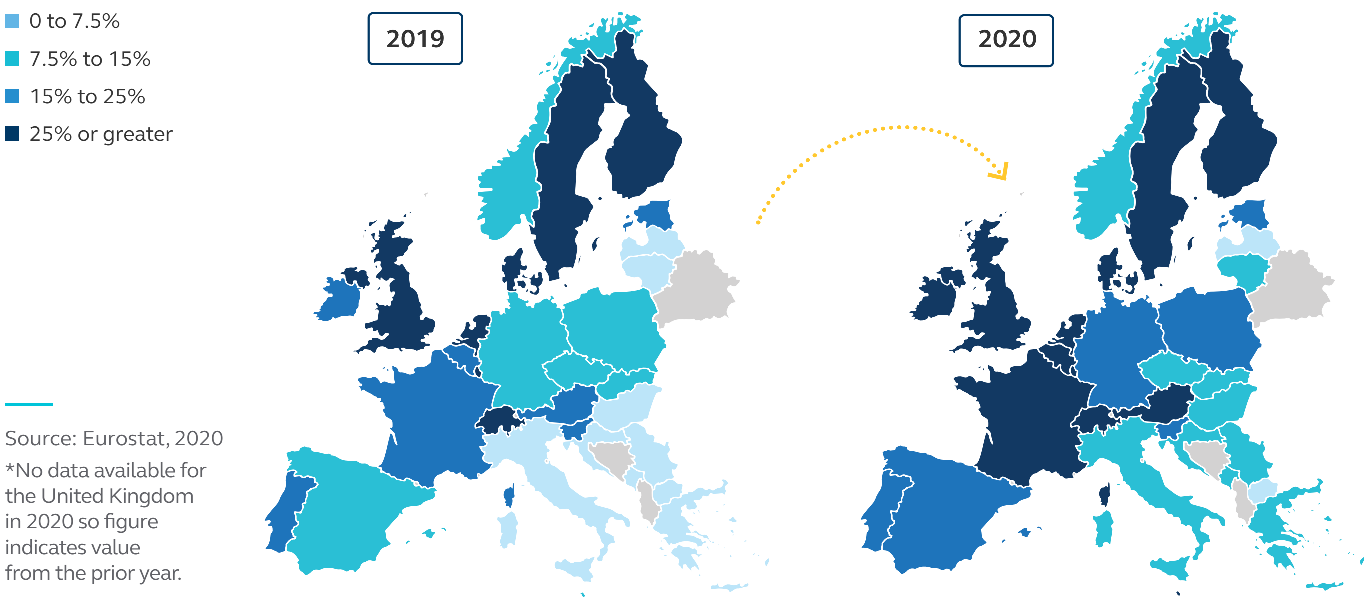
Life science and medical office solidify demand

The COVID-19 pandemic could have been much worse had it not been for the speed with which research and development was able to generate effective vaccines. Life science and medical office buildings have become critical to society and investors. Tenant demand is extremely robust for these technology intensive industries and sectors, which are also very resilient to remote work trends, due to the lack of substitutes for specialized medical or lab space. Although deals are difficult to come by, these sectors are now some of our strongest recommendations within the office sector.

Europe's office culture is robust, but WFH trends were established prior to the pandemic

The pandemic forced all office going employees into remote working, exposing the benefits and challenges of doing so. While WFH was novel in many markets and industries, some regions had established remote work models prior to the pandemic. The Netherlands, Nordics, and the UK were already versed with a higher tendency to work remotely and can offer some unique insight into the path forward for the broader office sector now that other regions are beginning to adopt remote work. Although there will be some reversion to the mean after the pandemic fades, Europe will undoubtedly see an increase in WFH adoption, making it critical for investors to understand case studies as they navigate the future of the office sector.

EXHIBIT 3: Some countries had ingrained remote work into their routines prior to the pandemic
Percentage of employed persons working from home sometimes/usually



Source: Eurostat, 2020
*No data available for the United Kingdom in 2020 so figure indicates value from the prior year.

Dutch office provides a model for the future of office space

In the Netherlands, 37% of the workforce was working remotely in some capacity prior to the pandemic. As such, the closure of physical offices did not shock the sector as deeply as other regions. The quality and composition of the Dutch office stock is one of the key reasons that the impact was minimal. An effect of the hybrid work model is a focus on spaces with more amenities and buildouts which actively attract talent and ultimately create an exciting workplace. The Dutch even have a term for this, known as "Knuffelen", which refers to the emergence of coffee bars, ping pong tables, and leisure-filled spaces for employees rather than "Buffelen", which equates to industrious cubicle-driven workspace. The ideology revolves around the notion that workers will not venture into the office unless there is a significant draw which entices them. As a result, the Dutch office market has seen a lot of consolidation, with lower-quality spaces deprecated or redeveloped due to declining demand. Viewing this model, it is important for investors to consider the change this could bring about in other countries as employees further embrace remote work and exhibit changing office preferences.

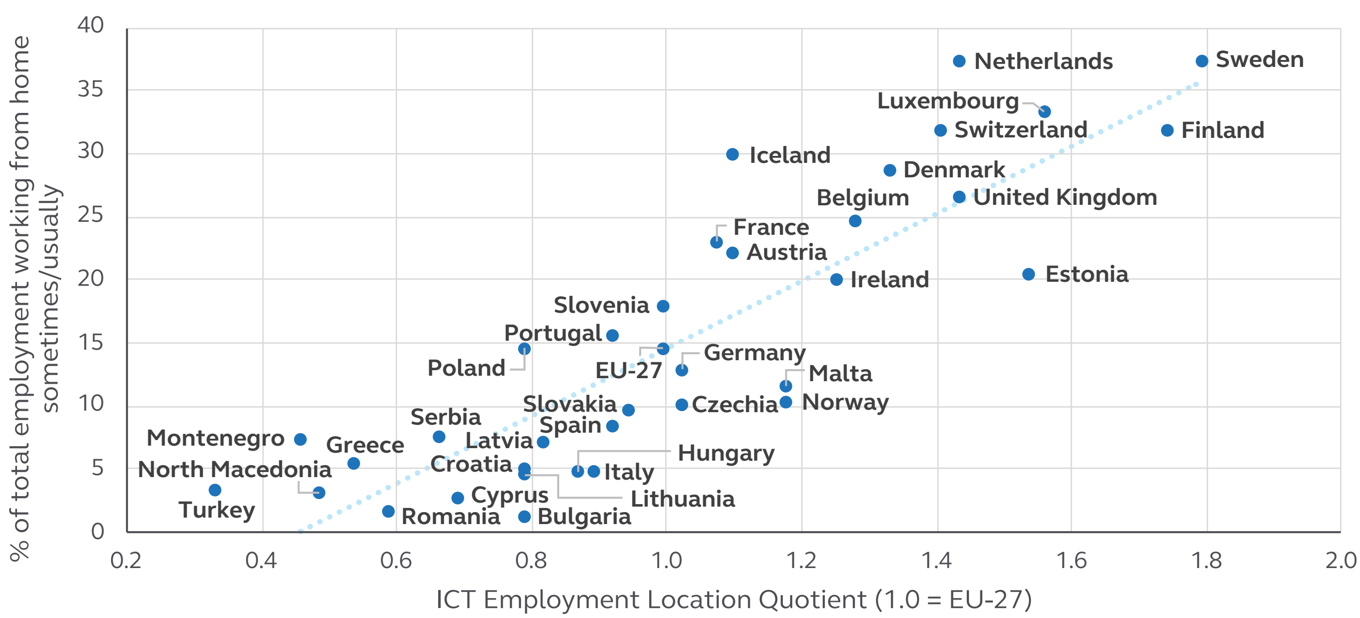
There is still a strong office culture that is deeply ingrained in Europe's diverse urban centers, however. Many workers may favor a hybrid remote structure but employers, especially at larger firms, will ultimately dictate future remote work policies. To this end, there is a balancing act that companies will need to maintain to give their workers flexibility while still maintaining a corporate culture and identity, which has historically been formed in the office. This is also a reason why workers may continue to be drawn into the office when given the choice because they don't want to miss out on collaboration and career opportunities. This is particularly true for younger workers still establishing their careers and network across an organization or new hires needing to undergo onboarding processes.

Industry concentration may dictate future office trends

Culture is one differentiator for a willingness to work remote, but job industry and function is equally, if not more, important. The ability to work remotely varies widely by industry. This is partly due to the technological freedom of some jobs—for example, software developers or technology personnel—which tend to have a workflow that keeps them untethered to an office. Industry employment concentrated within Information, Communication, and Technology (ICT) is one area which tends to have a greater freedom to work in a remote capacity. When viewing the data, countries with a greater concentration of employment in ICT industries indeed tend to have a greater propensity to work remote (See Exhibit 4). This will be an important distinction going forward for ICT clusters, such as the UK and Nordics, which have a portion of their workforce that is capable, and often enthusiastic, about remote work.

EXHIBIT 4: Workers in the ICT industry have a greater capacity to work remote

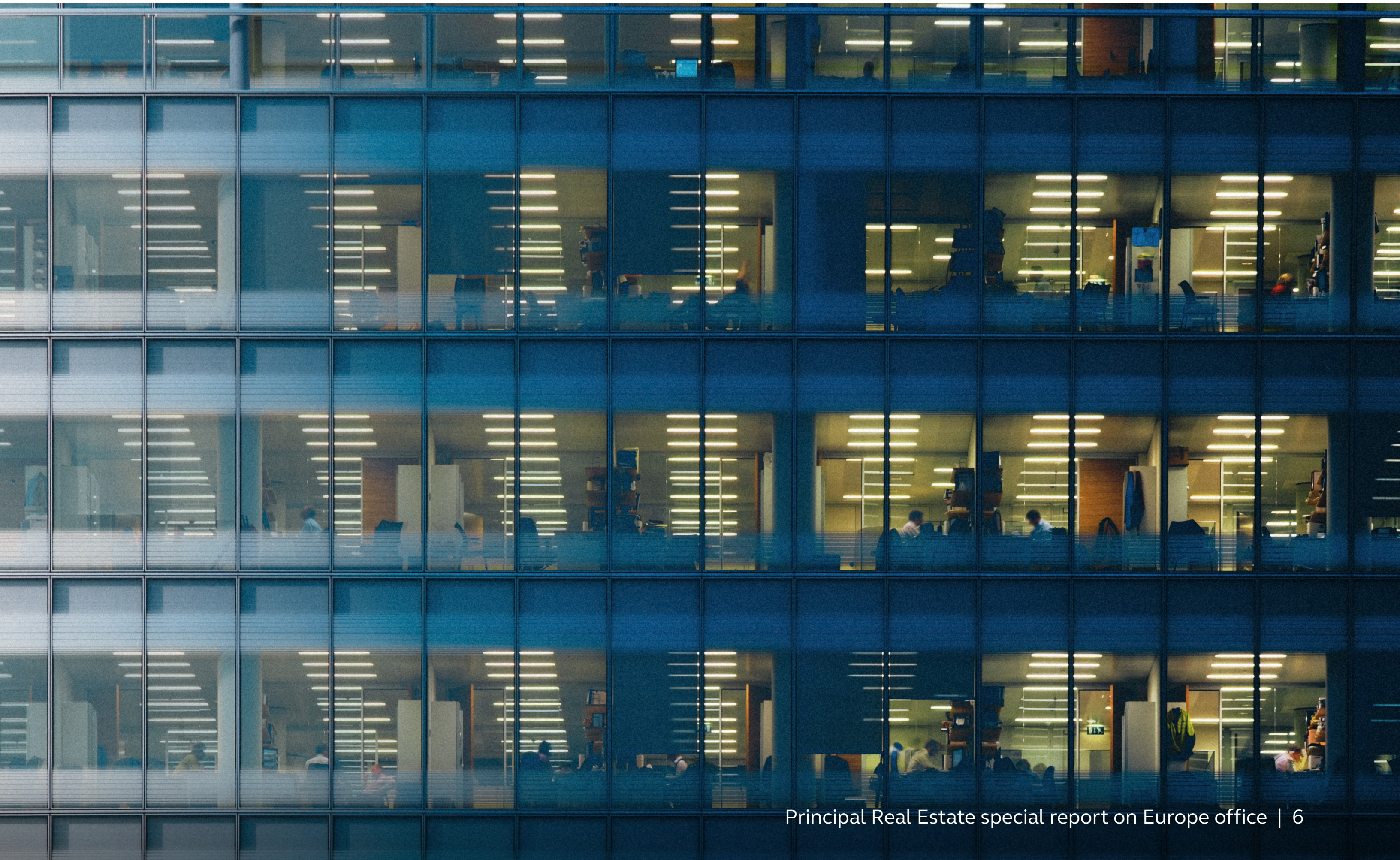
ICT employment vs. working from home



Source: Eurostat, 2019

The technology sector is also one of the fastest growing, as these workers are often considered crucial to the competitiveness of modern economies. In fact, technology and innovation are key pillars of our DIGITAL thesis and have led to significant growth for commercial real estate investments due to ICT's high growth multiplier on other industries. While it remains a structural driver of real estate growth, the near-term demand for traditional office space may be diminished by the presence of tech workers as the sector rebalances. This will put additional pressure on current owners in regions with a high concentration of ICT employment to create a compelling workplace environment which actively draws in workers. This also reinforces the view that office space will need to feature attractive amenities and increasing ESG components if employers aim to pull their workers into the office.

Conversely, areas with office workers that are incapable of remote work may exhibit resilient demand since many job industries require face-to-face interaction. Germany, Spain, and Italy have a higher concentration of industries that require interactions and may see more robust future demand due to their tendencies to work remote less. Industries such as manufacturing, healthcare, engineering, and research and development are inherently resilient to remote work. Alternatively, industries in marketing, consulting, or graphic design find themselves with greater freedom to work remotely. Many of these remote industries, however, are seemingly in conflict trying to balance an in-person office culture alongside employee demands for a hybrid work style. Some banks and financial firms, for example, have grabbed headlines for their lack of flexibility as they attempt to bring their entire workforce back into the office. Regardless, industry concentration will play a key role in future office demand for markets as some industries begin to permanently incorporate a flexible work schedule.



The future of office – what to expect going forward

Office is, and will be, an integral component of European real estate portfolios. There will be near-term turbulence, however, as demand looks to adjust to the new introduction of hybrid work models. The near-term effects of the sector will continue to be felt strongest in regions which had a low affinity for remote work prior to the pandemic and struggled to transition to temporary remote work. Many of those same regions will, however, exhibit stronger demand once a return to normalcy is underway as their job industries are more dependent on physical office structures. Exhibit 5 below highlights some of the key differences in office markets and highlights the cultural and regulatory variances that make it such a heterogenous investment opportunity. For example, in Spain, a recent royal decree disincentivizes remote work due to greater costs for employers to cover the burden of working remotely.

EXHIBIT 5: Different countries have seen varied responses to emergency remote work and a return to normal

Germany:	Home office obligation has expired but companies are still required to have an operational risk assessment in regard to COVID-19 risk. Hygiene and a safe workplace will be key points in the risk assessment. Yet the revised rules may still require employers to allow employees to work from home if office space is to be used by several people and there is not enough space to maintain adequate social distancing.
France:	The French Labour Ministry removed the obligation for employers to set a minimum number of days of homeworking in order to fight the COVID-19 pandemic (Sep 1). However, many French companies are planning to make remote work permanent, at least for a few days a week, in order to meet demand from their employees.
United Kingdom:	Although the legal obligation to provide a remote work option has expired (July 19th), the government is still recommending a gradual return to the office for employers. The guidance allows employers to judge their own risk and determine steps rather than forced mandates.
Spain:	Employees will have to adhere to employers' wishes on a return to the office. The right to telework in a state of alarm or for business continuity was in Spanish law prior to COVID-19, however. Royal decree law signed in 2020 also requires employers to pay any costs that cover the burden of working remotely, which may leave some grey area for interpretation.

Source: Principal Real Estate, December 2021

Future office investments may also change course due to some of the trends brought on by the pandemic. The rise of WFH may lead to a consolidation in office stock and office owners will need to ensure that their space is appealing for workers who now have a greater propensity to work remote. Nearly all office buildings will need to meet newfound health and ESG expectations which have emerged from the pandemic. Tenants will place greater importance on upgrades to air filtration, more open spaces, and creatively redesigned workspaces. In fact, reports from office REITs in Europe are already reporting that newly modernized construction are better leased upon completion. Lastly, there may even be some rebalancing between markets as employers reimagine where they can conduct business. In this sense, smaller regional markets are likely winners due to their reduced office costs and living affordability. This would likely be concentrated in smaller companies which have fewer costs and employees.

Conclusion

The office sector faces near-term challenges but the lack of new supply along with a high degree of familiarity with WFH means that most markets should revert or remain in equilibrium. This should lead to a robust recovery for the sector, though there will be distinct leaders and laggards. The trends of remote work that were brought on by the pandemic are here to stay but it is important to recognize the regional differences that will impact fundamentals and investment performance. As investors look to recalibrate their portfolios it will be important for them to recognize these significant geographical trends. Additionally, the movement towards higher class office space with greater amenities may lead to some interesting redevelopment deals for investors with a greater risk appetite.

We feel confident that the office sector will continue to remain an integral part of investor's portfolios. The current environment is now increasingly nuanced, with job industries, policy, and cultural differences acting as key differentiators. These changes will increasingly force office owners to adapt quickly to meet tenant demand. We believe office investments which coincide with our DIGITAL strategy will still see long-term outperformance.

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