

**An Early Investigation into the Effects of Covid-19 on UK
Commercial Real Estate Economics and the Factors
Affecting Supply and Demand with a Focus on Buildings
Close to Transport Hubs**

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Abstract

This report analyses the potential impact of the Covid-19 virus, on the UK economy and its subsequent effect on UK commercial real estate. This study discusses the contributing factors, which consist of Information Technology, Human Resources and Real Estate, with a focus on the importance of transport hubs, and their effect on supply and demand for buildings, with regards to desirability.

My study was undertaken in April 2020, with the aim of anticipating and predicting the future implications of Covid-19 on Real Estate. My findings look to reveal how changes in macroeconomic growth of the UK will also influence desirability and development in both the short, medium and long term.

My research suggested that human nature desires interaction, for it is only by being collaborative that true creativity is unleashed. This suggests that there will always be a need for group working, within a given space; there will always be a demand for commercial real estate, provided it is easily accessible and tailored to ensure employees feel comfortable within their working environment.

This pandemic is current and the policies surrounding it remain a work in progress. It has therefore been challenging to find factual evidence, reports or data. My study remains hypothetical as only time will show the true extent of the effects of Covid-19 on UK commercial real estate economics and the factors affecting supply and demand with a focus on buildings close to transport hubs.

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'Wishful thinking is a powerful thing'¹, especially with regards to Covid-19, the new externality to the world's economy, yet to be branded as positive or negative. However, at this early stage, mid-April 2020, the future looks bleak for overall health and wealth.

History has proven that we should be careful of viruses. Spanish flu stopped, for a short period, the world's worst war. SARS, MERS and Ebola felled approximately 15 000, although their influence was mostly contained geographically. To date, 160 000 people have died worldwide from Covid-19 which has killed mostly those of older age and/or those with under-lying health issues. Covid-19 attacks those least able to resist a virus i.e. those with low immune systems. There are exceptions to these groups, but they are much smaller in number.

In essence there are two ways to look at protecting one's population from Covid-19 - the "herd method" or the "isolation method". These views can be categorised by the different modelling studies purported by Oxford and Imperial Universities respectively. Unfortunately there is no correct answer since the world currently lacks the data to record the majority of Covid-19 infections. Many of us may have already unknowingly contracted the infection and have therefore developed a degree of immunity. However, like most Coronaviruses, this protection may only last 2-3 years.

When analysing risk, the Imperial model suggests that large numbers of deaths represent a higher risk to society than short term economic stagnation, since the mortality rate could otherwise reach 500 000. The Imperial model relies on isolation and quarantine to break the flow of transmission, person to person, community to community. By implementing this methodology and social distancing, the peaks of the contagion rate curves can be truncated and hopefully be spread out or reduced over time. However, this strategy has a seriously negative effect on the economy and consequently on commercial real estate itself.

In the modern, pre-Covid world, real estate was driven by companies to maximise economic efficiencies. This led to the removal of individual offices in favour of open plan, increased density of desks within an area, and the focus on 'sweating the asset', to the detriment of other factors. Office desks have shrunk over the years, from 1.8m to 1.6m, to now 1.4m and less². However, there are positives; firms have started to incorporate health and wellness into their real estate strategies. This normally includes gyms, cafeterias, and in the most cutting edge firms such as the new technology companies of Facebook and Google, massage rooms, sleep pods and medical facilities to support their staff. Over the past decade, these companies have also changed the way in which corporates have designed their offices. A key example being open plan areas designed for collaboration and productivity, allowing unimpeded flow of information³ over and above the economic efficiency

¹ Tim Harford, The Financial Times, April 2020

² Arjun Kaicker, Zara Hamid Architects, The Guardian

³ Triumph of The City, Edward Glaeser

of the company. Indeed Michael Bloomberg attributes much of his success to the recognition that “knowledge comes from proximity to other people”.

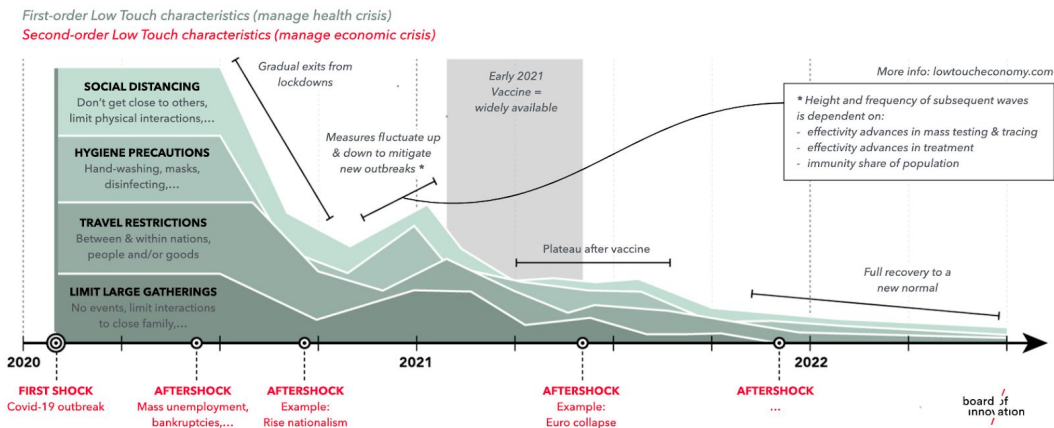


Figure 1: Example of what the next 18-24 months could look like⁴

Historically, property values have been driven by the old adage ‘location location location’. Prime real estate was located around the historic centres of commerce, e.g in London the West End centred around Oxford Circus, and in the City around the Stock Exchange. With the advent of improved transportation, these prime areas have begun to move to estates surrounding major transport hubs. For example, in 2001, Kings Cross was considered to be a secondary location, fit only for government and corporate back offices. However, in 2015 this was reversed as the concept of connection and time-space compression, made Kings Cross a new business hub and a prime district for firms to be located. It is the importance of a good quality transportation system and hence the removal of friction for employees to get to work, that instigated the transition from secondary to prime. This phenomenon is also evident at Victoria Train Station, Cannon Street and The Bull Ring in Birmingham (New Street Station). Smaller cities, such as Cambridge have witnessed similar changes with the creation of CB1.

Although these criteria are relatively new in terms of real estate, the concept of being close to the centre, or to the centre of commerce is anachronistic - recall the market place in medieval days. As American reformer Theodore Parker cited, ‘cities have always been the fireplaces of civilisation, whence light and heat radiated out into the dark.’ As such, ‘the megalopolises of New York, London, Tokyo have always been catalytic forces driving innovation, growth and trade’⁵ which supports recent research showing that “productivity is significantly higher for firms that locate near the geographic centre of inventive activity in their industry”⁶

The current question is, have the sensitivities of employees in a post Covid world changed what is considered to be prime? I am of the opinion that prime real estate is driven by a combination of three factors, Information Technology, Human Resources, and Real Estate.

⁴ Board of Innovation. 2020. *What Is The Low Touch Economy?*

⁵ Richard Pickering, Chief Strategy Officer, Cushman & Wakefield, UK

⁶ Triumph of The City, Edward Glaeser

Each of these equally influences the future of demand for offices in a specific location. This is particularly true in markets where corporates are competing for the best talent, and 'place' forms an important role in a potential employee's decision to join or otherwise.

In a Covid world, where all but the non-essential work is carried out from home, the knowledge worker is fully removed from the office workplace, but remains connected through the systems driven by cloud enterprise. This allows connectivity and collaboration through shared documentation, video conferencing, laptops and the mobile phone. No longer is the knowledge worker, or indeed any worker, tied to a specific desk, a specific building or a specific location. Covid-19 has necessitated that these workers embark upon an experiment in how to maintain productivity, whilst maintaining physical distance from colleagues and workplace. Fortunately technology has enabled this to succeed in a fundamentally seamless manner. For those unable to leverage these facilities however, this situation has been catastrophic. People whose jobs are not transportable in this modern way, face unemployment both in the short and possibly in the longer term. To date it is expected that the UK GDP will fall by £180 billion. This is the equivalent of 6 million people of working age earning an annual salary of £30k, which is just above the UK's average wage⁷. Certainly IT enables this progress, but HR policies are still required to manage people, so that they can stay focused, productive and aligned to their corporate goals.

HR and management policies have until recently been driven by the idea of a 9-5 working week and an employee's physical presence in the office. If you were not present then you were considered to be not working. We can see extreme examples of this HR and management policy in places such as Japan, where workers feel obliged to 'out stay' their boss. More recently, these expectations have relaxed. However, in a Covid world where everyone works from home, no manager can be sure when their employee is working. In order for home working to be successful, firms must ensure that they have flexible management structures and that management itself is able to adapt to these new processes. Looking forward, I anticipate that many more people will have the opportunity to work from home, either as an alternative to working in the office or as an additional form of work setting. An employee will have actively chosen which environment best fits the work that they have to undertake. For corporations to be successful in the future, they will need to accommodate these Covid experiment findings. This new reality will bring significant economic benefits and many CFO's may well lack the motivation to reintroduce the old regime.

For Real Estate, the changes in technology and the adoption of new HR working practices, will require novel ways of thinking about the "role of the office" and Real Estate in the corporate philosophy. As stated by Rami el Samah, 'this won't be the first time in history that cities and buildings will be reimaged or redesigned in response to an increased understanding of disease'.⁸ The time when offices were a place just to work has probably reached a conclusion. Precipitated by the Covid-19 crisis, the office is no longer essential in order to undertake office tasks. Such work can now be done any place, anywhere, at any time and has been fully substantiated by the 'Covid experiment'. This will have a

⁷ Wake up to money BBC Radio 5 podcast

⁸ Rami el Samah, Principal at Boston Architecture and Design Firm OverUnder

fundamental effect on the role of real estate, and hence on the demand for real estate in a post Covid society.

If we integrate modern office design, we generally see open plan, linear desk layouts with a smattering of individual offices and an appropriate number of meeting rooms. In a post Covid world, social distancing, at least until mid 2021, is likely to be the dominant factor in how we utilise our office space. Arjun Kaicker (ZHA) agrees that 'we'll see wider corridors, more partitions, and a lot more staircases'. Arguably we will need to instigate a 2m rule between all employees, affecting the number of useful desks and shared/utilised meeting rooms. Furthermore, we will need to consider 'passing space' and how this will affect the serendipitous collision. This discussion appears endless with suggestions that we could see 'the addition of building materials that discourage the spread of germs... and access to rooms and elevators without employees having to touch a handle or press a button'⁹. The need to collaborate and a place for 'heads down' work requires consideration. Assuming an office has standard desks measuring 1.6m by 0.8m, the design could only be utilised on an odd even basis (i.e every other one). Consequently, the capacity of any existing office space is now fundamentally reduced, most likely to 30-50% of its original number. On this basis, we could anticipate that we will need double the amount of space. However, this does not necessarily factor in the element of working from home which could completely offset the need for these 'lost desks'. One significant consideration is that if working from home is to become the new normal for many, the challenges for real estate and construction will be amplified further. Whilst we have lived in a world of people travelling to work, living spaces have become cramped, with minimalist preferences, especially in cities. The Covid era has shown the limitations of the space in which we live - for many, blending living and working areas is not compatible, so the demand for more spacious living could rise to enable the work/life balance to be maintained in a home office environment

It is likely that the drive for social distancing will wane over time due to the human need to be together, and the overriding economic drivers of the corporate. Christos Lynteris, medical anthropologist agrees. He is sceptical about how much Coronavirus will actually change anything. In April 2020, he told The Guardian that 'epidemics and pandemics have their own temporality... panic dissipates very quickly and people rarely follow up'. Nevertheless I believe that the employees of today and of the future will demand a greater degree of safety in their internal environment and the surrounding air quality. Dockser cited 'I think we will see a much greater focus on the air quality in buildings. The ability to demonstrate good air quality will mean people will stay longer in your shopping centre or hotel. In the absence of a treatment and a vaccine we must do the best we can ... and signal to people what we are doing. It won't be sufficient to just tell people that spaces are clean; people will need to be able to smell that they are clean, and people will need to be able to see workers cleaning the buildings, so they will be more comfortable being inside them.'¹⁰ This will necessitate a change in the basic constructs of the office layout and consequently in the overall requirement for real estate.

⁹ The Sydney Morning Herald, Jane Margolies

¹⁰ Bradford H. Dockser, Chief Executive of Green Generation in Bethesda, Maryland

I believe the workforce will be split into several categories; those whose attendance in the office is vital, and workers at the other end of the spectrum who will never or only rarely need to attend the workplace, since their roles can be carried out as effectively from home, or from an alternative location. Current research indicates that for some individuals remote working is 43% more productive than working in the office¹¹. Assuming this, it is likely that the overall requirement for office space will drop as there will be less people requiring a 'one to one' person to desk solution and many more opting for an agile/shared desking solution.

Agile working is not necessarily new - we have seen many large auditing firms already utilising this methodology to reduce their base cost for their audit teams. The only companies that have instigated working from home as a general philosophy are no longer with us, for example Sun Microsystems. Hence we need to ensure that once instigated, an agile/working from home solution is applied to those employees where it is most appropriate.

In terms of office design, we will need to address the requirements of these categories. On this basis, the future office is likely to become a place to meet, to discuss, to collaborate, whilst the heads down work will be completed elsewhere, probably in a home office. In essence, the office of tomorrow is more likely to reflect the situation in medieval England where a large number of the population worked on their remote farms only coming to town on market day to sell their products and to meet their customers and suppliers. It is likely that we will have a modern version of this solution. Although IT enables connectivity, we still appreciate the face to face meeting, as it is generally still regarded as more powerful and productive. As Peter Hall in Cities of Tomorrow noted, 'these new activities were supposed to substitute for face-to-face communication, but actually they depended on it, and in turn fortified the need for it'. This coincides with the economic principle, Jevons paradox which 'occurs when technological progress...increases the efficiency with which a resource is used..but the rate of consumption of that resource rises due to increasing demand'¹²

On this assumption, even with some element of social distancing and an increase in collaboration facilities, it is likely that the overall demand for core real estate will reduce. Estimating conservatively, there could be a reduction in demand of 30% on current real estate requirements. This would have a detrimental effect both on rental levels and capital values, which could ripple through the economy as most commercial real estate forms a significant part of commercial and pension fund investment.

A fourth factor that could affect commercial real estate is the influence of transport and the sensitivities of commuters to proximity during rush hour and the trade off of commute time versus working from home. As with office design, social distancing will be on every commuter's mind. However, I believe that over time one's desire to sit will overcome the need for social distancing. That said, I feel individuals will want to minimise their travel times and to reduce the number of interchanges from one form of transport to another.

Interestingly, if corporates drive to a greater working from home experience for their employees, this could mean that travel frequency is likely to reduce. Consequently,

¹¹ Alain Dehaze, CEO of The Adecco Group

¹² Wikipedia

commuters may be willing to trade a less frequent commute for a greater distance or time. This may benefit the corporate inasmuch as it could increase their talent hinterland. However, it does mean that the firm's office must be well located at a central transport hub, allowing both those who live close and further afield, easy office access. Alternatively, but using a similar philosophy employees must at least have access to office space near a transport hub, which in some cases will not belong to the employer, but to a third party, who will then charge a user rate to the employee's company. We have seen this solution being delivered by serviced offices such as Regus and more lately WeWork.

If this assumption regarding commute and transport are correct, it is possible that prime may shift from the more traditional locations and establish dominance in those areas surrounding transport hubs.

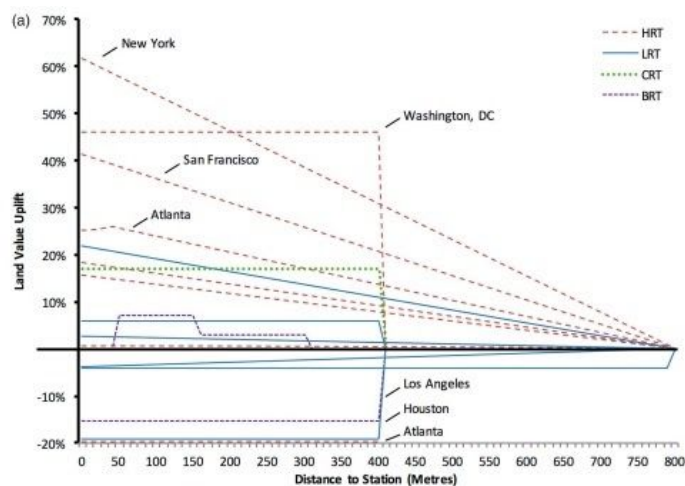


Figure 2: A graph showing the distance from transport hub vs land values for major US cities¹³

In this case, real estate around these hubs is likely to experience greater demand, whilst those in more peripheral areas are likely to see a reduction. Consequently, rents and capital values around these central hubs are more likely to increase as they will be more sought after by those companies competing for talent. As stated by Laura Bliss¹⁴, 'the logic is pretty consistent: Build a rapid transit station, and land values are supposed to jump up'.

In conclusion, regarding the factors of demand for real estate, a significant driver is the successful collaboration between the triumvirate of IT, HR and Real Estate, plus the influence of the transport infrastructure upon a location. The more a company can instigate a successful IT enabled work-from-home policy focused on collaboration, and creativity, the more likely it is that it will require its offices to be well located on a transport infrastructure hub. Assuming all modern successful corporates are striving for increased productivity and efficiency it would make sense that those buildings closest to an infrastructure hub will become the most sought after, therefore positively affecting rental and capital level values.

¹³ Laura Bliss, The City Lab

¹⁴ Laura Bliss, The City Lab

Regarding supply, Covid brings uncertainty and risk. As with all industries, particularly real estate, uncertainty and ambiguity reduce the desire to develop and invest - the development cycles for real estate are long. Moreover, greater uncertainty means that developments and their pipelines become more reserved and so the volumes developed are reduced. In cities where land is already at a premium, this means that those involved in the real estate development process are unlikely to take the necessary risk to deliver more offices.

From a macroeconomic perspective, it is expected that the UK debt to combat the Covid-19 virus will be in the region of £2 trillion. This "Covid debt" is of an order of scale similar to that of the Anglo-American Loan, which the UK borrowed to fight WW2. This "War debt" took 60 years to pay off fully with the last payment being made by George Osborne in 2006. Despite current low interest rates, it is likely to take a similar timescale to pay for Covid, creating a debt for my children and my children's children.

At some point in the near future, this national debt will need to be repaid, most likely via taxation of the national economy. The government will have to instigate policies to promote economic growth and wealth, as only a wealthy country will be able to repay its debts. To do this, the government is likely to instigate both economic and fiscal policies, along with currency competition. However, with these measures comes the risk of inflation. In normal circumstances, the government would raise interest rates but with such a massive debt this decision could have negative consequences rippling through the system, such as increased unemployment and austerity.

Although there are similarities between the "war debt" and the "Covid debt" the former was incurred only by those fighting in the War. With Covid we see a global element, where almost every country will incur significant debts, even Sweden. If all countries are in the same debt situation and the global economy is so damaged, could it be possible that we will witness some sort of mass recalibration to countermand this debt? It is implausible to expect that every nation or currency block will be able to finance their debts.

Excepting this hypothesis, Covid will affect the UK national economy with the increased debt being a "drag". However, with sound policies, the economy could continue to grow, thereby encouraging business to expand and by extension the real estate market to develop. The wrong policies will drive the opposite scenario. It will therefore be interesting to see how Covid will impact the Brexit negotiations and the UK, especially since, 'the coronavirus crisis means that a hard Brexit is now likely at the end of 2020: there is no focus on negotiations, and the timetable was already very tight. Further, with the disruptions to trade, supply chains and movement, many of the costs of a hard Brexit have effectively already been incurred and firms will make permanent adjustments ahead of the deadline'.¹⁵

Considering these macro factors, it is likely that the demand for real estate will reflect the basic health of the UK economy. If the UK is progressing well then real estate values will increase as will the development pipeline, albeit lagging demand due to the long-tailed nature of planning and construction. If the UK is progressing poorly, then real estate values

¹⁵ Simon Baptist, Global Chief Economist, The Economist, Intelligence Unit

will stagnate or fall with only prime likely to hold its demand as corporates trade up the value scale.

To conclude, Covid-19 will be a major influence on UK real estate in the short, medium and long-term. Short-term, Covid-19 will influence property demand as the implementation of "social distancing" will require offices to de-densify, increasing demand, since many CFO's will be reluctant to make any major capital investments that can only be recouped over the short-term ie the 2-year Covid-19 contagion period. Similarly, it is unlikely that there will be a significant long-term easing in density as ultimately CFO's and cost pressures will remain .

So although there is pressure to de-densify, there is the equal and opposite driver of new working practices and the implementation of improved work-settings. The latter have been made possible by improved IT solutions. Likewise, modernised HR and management techniques will help to make these changes possible. As Richard Pickering said in his recent article 'industry discussion has re-focussed from managing the cost of real estate to using it to create enterprise value for corporations. Here is a clear example of how a 'safe' adapted environment could deliver significant value for organisations, faced with the binary alternative of not being able to trade.'¹⁶

The other major influence on the commercial 'place' is efficient, quick and safe transportation. Forty years ago, corporates moved out of cities to the suburbs. Then 20 years later they returned to their cities, driven by improved public transportation and the desire to capture the younger talent, since 'people are inherently attracted to everything cities offer'¹⁷. This trend is likely to continue, assuming corporates remain close to the transport hub. Those located further away from these new prime centres may start to look for an out of town solution that can provide them with an alternative talent hinterland, but transport links will be key. Just think Cisco and Stockley Park.

As James Carville, Bill Clinton's Strategist quipped in 1992 'it's the economy, stupid'. Covid-19 has successfully destroyed the UK economy adding a £2 trillion debt that future generations will have to pay back. Unless the UK government instigates good business initiatives, the UK economy, like many other countries, will suffer for years to come. This will affect both supply and demand for UK commercial real estate.

So, location, location, location will remain paramount. Demand for commercial offices may reduce due to modernised working practices, but is likely to be off-set by 'safe and collaborative' adapted environments delivering significant enterprise value. The economy as always will drive market forces and influence both the overall demand and the supply pipeline, but because of timing it will create peaks and troughs in rentals and capital values.

Ultimately the benefits of an easily connected office will always be the crucible of creativity, collaboration and business success, 'as...all creative activities, depend on interaction...a

¹⁶ Richard Pickering, Chief Strategy Officer, Cushman & Wakefield, UK

¹⁷ Mark Wilsmann, Managing Director and Head of Real Estate Equities Strategies, MetLife Investment Management, New Jersey

certain amount of buzz and fizz'¹⁸ and as such these buildings will always be in greater demand as a matter of preference against others, driving up their value.

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¹⁸ Peter Hall, *Cities of Tomorrow*