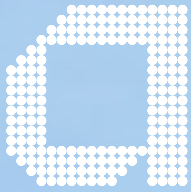

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# Offices: re-evaluating the FACTS

Q2 2023

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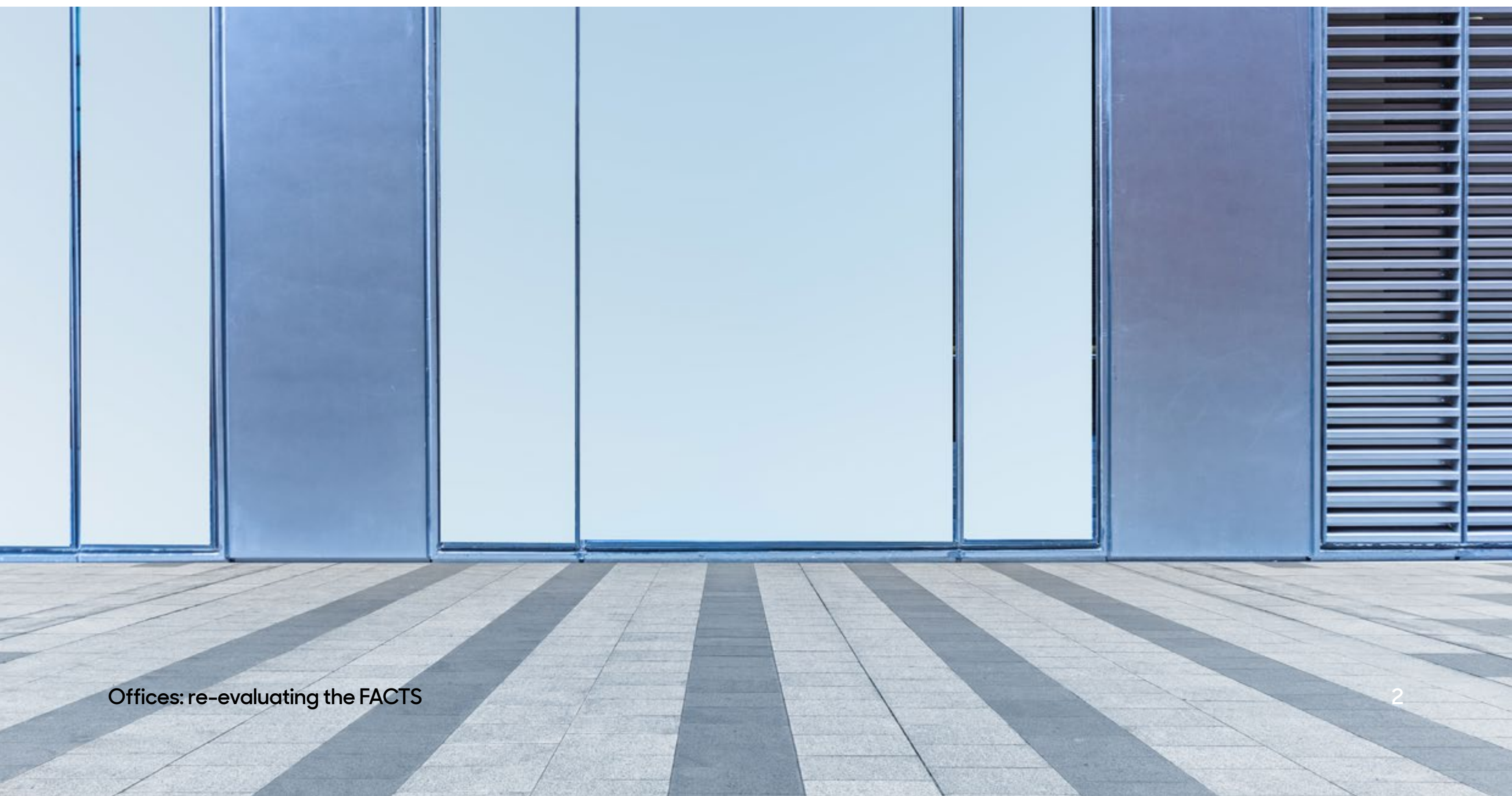
# Executive summary

- It has been two years since we first introduced the FACTS (flexibility, amenity, connectivity, technology and sustainability) framework to evaluate office space in the post-Covid world. While some trends have played out broadly along the lines that we had envisaged in mid-2021, others have turned out differently. We expected more flexible working, a flight-to-quality, and rent premiums for FACTS-fit offices, but there has been less emphasis on de-densification than expected. The difference in how occupiers behave (and how that has affected pricing adjustments) across different markets also appears to be starker than what we had anticipated.
- We believe the five FACTS factors have become even more important today for offices to remain competitive. This is especially the case in three key areas. In terms of flexibility, companies are trying to increase the amount of flexible space in their portfolio, including working with third-party providers. For amenity, the hardest-hit offices have been in the US, which has the most vacant space post-Covid. Most of the office space was built between 1980 and 2009, and is located in areas with high crime rates and with few external amenities. The third key area is sustainability, where 3-3.5% of existing office stock needs to be retrofitted every year to meet the net-zero target by 2050 (the current rate is just 1%).
- For offices that score poorly under the FACTS framework, we think it might be helpful to run the asset through a sell, upgrade or convert screen (or SUC-S) to determine the next course of action. Overall, we rank the upgrade route (FACTS refurbishments to enhance competitiveness) ahead of the conversion route (mainly to residential use). An upgrade is likely to involve fewer complications, especially if the building is not fully vacated. That said, a conversion is preferred over a redevelopment from a cost-and carbon-footprint perspective. When neither an upgrade nor a conversion is feasible, a sale is then recommended.
- Notwithstanding the pricing adjustments so far, we believe there is room for further corrections to incentivise more FACTS upgrades and/or conversions to alternative uses. The average office yield for the fourth quarter of 2022 was 5.6% across major global cities. Using this figure as a benchmark, our estimates suggest that the entry yields may need to be at least 140 basis points (bps) or 25% higher in the case of a FACTS upgrade. In the case of a conversion to residential use, entry yields would need to be 700bps or 125% higher to be feasible. In the latter case, there are also physical constraints that have made conversions either too challenging or costly.



# Revisiting the FACTS: how markets have evolved

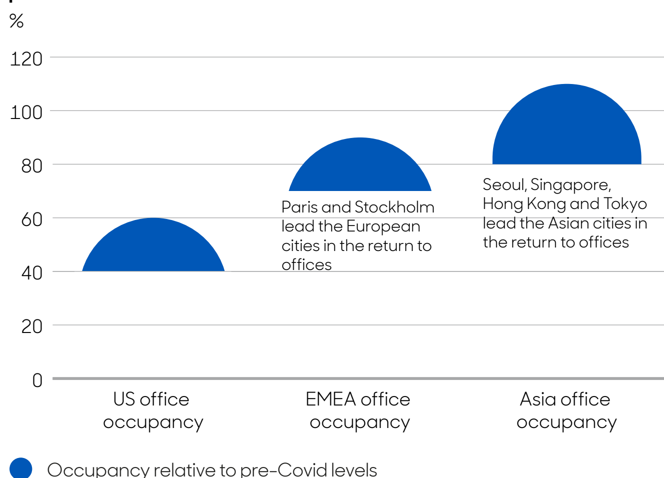
We published two papers on the office market in May 2021: **Offices: FACTS or Fiction**; and **Getting the FACTS right: value-add office strategies after the pandemic**. These papers introduced the FACTS framework as a way to evaluate office space in the post-Covid world. The papers laid out the investment case for value-add strategies that target higher FACTS scores for buildings to stay ahead of competition.

Now that the pandemic is behind us, and considering we now have some evidence of post-Covid occupier behaviour, we think this is a good time to revisit our views and update where necessary.

Some of our observations so far include:

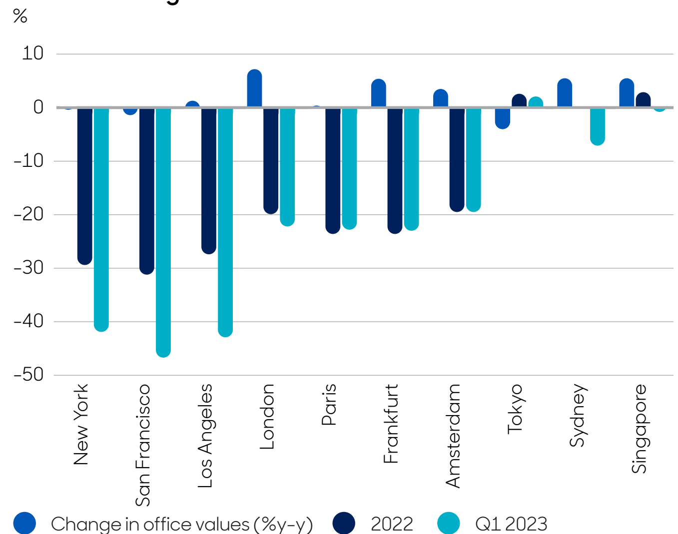
- We had thought that de-densification would partially offset the impact of working from home and that it would lead to a 15-20% reduction in office demand over the longer term in some markets. We expected the loss to be concentrated in poorer-quality assets in weaker locations. While flexible working has certainly become more prevalent, the experience so far appears to be quite different across markets. According to a **Wall Street Journal** report published in February 2023, **As Americans Work from Home, Europeans and Asians Head Back to the Office**, the return to the office has been slowest in the US. Meanwhile, office occupancy in Asia is now above pre-Covid levels in some markets (Chart 1). It also appears that there is now less discussion around de-densification, compared with when we were at the height of the health crisis.
- We had expected value-add opportunities to emerge in the 12-24 months from mid-2021, because we had anticipated that vacancy risks and a steeper yield curve would have weighed on non-core office values. While there is some evidence that the vacancy rate is increasingly concentrated in offices with certain attributes (more details in the next section), we could not have anticipated the surge in short-term interest rates that followed. This was mainly a response to inflationary pressures, with the war in Ukraine among the key contributors. Even then, the adjustments in pricing so far have varied across markets (Chart 2), with the US experiencing the most pressure. The correction in Asia-Pacific (APAC) has been relatively muted.
- We had thought that the rent premium for FACTS-fit offices, over standard core offices, could increase from an initial 10% to 22% by 2030. Since then, some evidence of a rent premium has emerged, which will be discussed in the next section.

**Chart 1: Office occupancy as a percentage of pre-Covid levels**




Source: Wall Street Journal (WSJ), citing Jones Lang LaSalle's (JLL) data, abrdn; February 2023.

**Chart 2: Change in office values since 2021**




Source: Green Street, JLL, abrdn; April 2023.

# Verifying the FACTS: even more critical for offices today

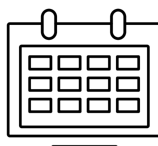
Compared with two years ago, when we first introduced the FACTS framework, we believe the five factors are even more important now if offices are to remain competitive (Chart 3). Consider the following:

- **Flexibility**. About 40% of companies surveyed by JLL (**The Future of Work Survey 2022**, August 2022) planned to increase the amount of flexible space in their portfolios over the next three years. This is especially the case for larger companies (44% for those with over 5,000 employees, versus 40% for those with fewer). Over half of these companies planned to lease flexible space through a third-party provider.
- **Amenity**. According to a CBRE report (**Office Buildings Hardest Hit by Pandemic Share Common Characteristics**, April 2023), the hardest-hit buildings (HHBs) are generally located in areas with higher crime rates and fewer external amenities like nearby restaurants. HHBs accounted for 80% of total occupancy losses between the first quarter of 2020 and the fourth quarter of 2022 across the tracked US markets. Importantly, CBRE estimates that if no widespread action is taken to remove, revive or repurpose these HHBs, they will push the long-term US structural vacancy rate to 14.5% (from 12%). In the UK, office vacancy rates appear to have a high positive correlation with equivalent yields (which is a proxy for quality – see Chart 4).
- **Sustainability**. Nearly 100 countries have committed to a net-zero target by 2050 and the scale of retrofitting older offices is huge, according to JLL (**Retrofitting Buildings to be Future Fit**, November 2022). Across 10 major cities in Europe and North America, 90% of office stock is over 10-years old, and even offices completed just over five years ago will likely not comply with future energy efficiency standards. JLL estimates that 80% of office buildings in mature cities that exist today will still be in use in 2050. This suggests these buildings need to be retrofitted at a rate of 3-3.5% a year if the net-zero target is to be met. Current retrofit rates in what JLL call the "Global North" are around 1%.

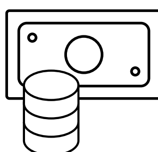
There is also some evidence that occupiers are prepared to pay more for space that scores well in FACTS. For instance, according to JLL's **Global Premium Office Rent Tracker** from December 2022, rents for 'premium' offices increased by 4.8% in 2022, outperforming the general office market. The report showed that 87% of premium offices have an energy efficiency-related certification, such as LEED (Leadership in Energy and Environmental Design), and 21% have a wellness-related certification, such as WELL Building Standard. These offices might score well in our FACTS categorisation. This was particularly the case across EMEA, where rental growth for premium offices reached 10.6%.

**Chart 3: How FACTS are even more relevant for offices today**

Around 80% of offices will still be in use by 2050. This means that 3-3.5% of stock needs to be retrofitted each year to meet net-zero targets. The current rate of retrofits is just 1%.[1]



The hardest-hit offices with the most vacant space post-Covid were mainly built between 1980 and 2009. They are located in areas with high crime rates and fewer external amenities.[2]



A flight to quality resulted in a 4.8% rise in rents for premium offices globally in 2022. The trend is particularly apparent in EMEA, where growth has reached 10.6%.[3]

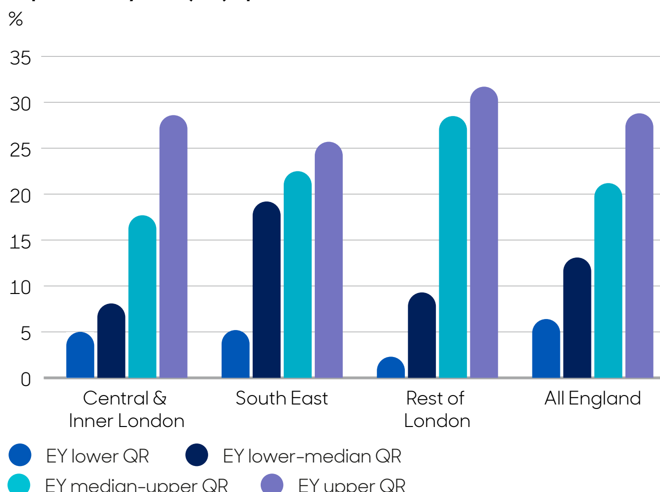
Source: CBRE, JLL, abrdn; April 2023.

[1] **Retrofitting Buildings to be Future-Fit**, JLL, November 2022.

[2] **Office Buildings Hardest Hit by Pandemic Share Common Characteristics**, CBRE, April 2023.

[3] **Global Premium Office Rent Tracker**, JLL, December 2022.

**Chart 4: Vacancy rate for UK offices by region and equivalent yield (EY) quartile, as at Q1 2023**



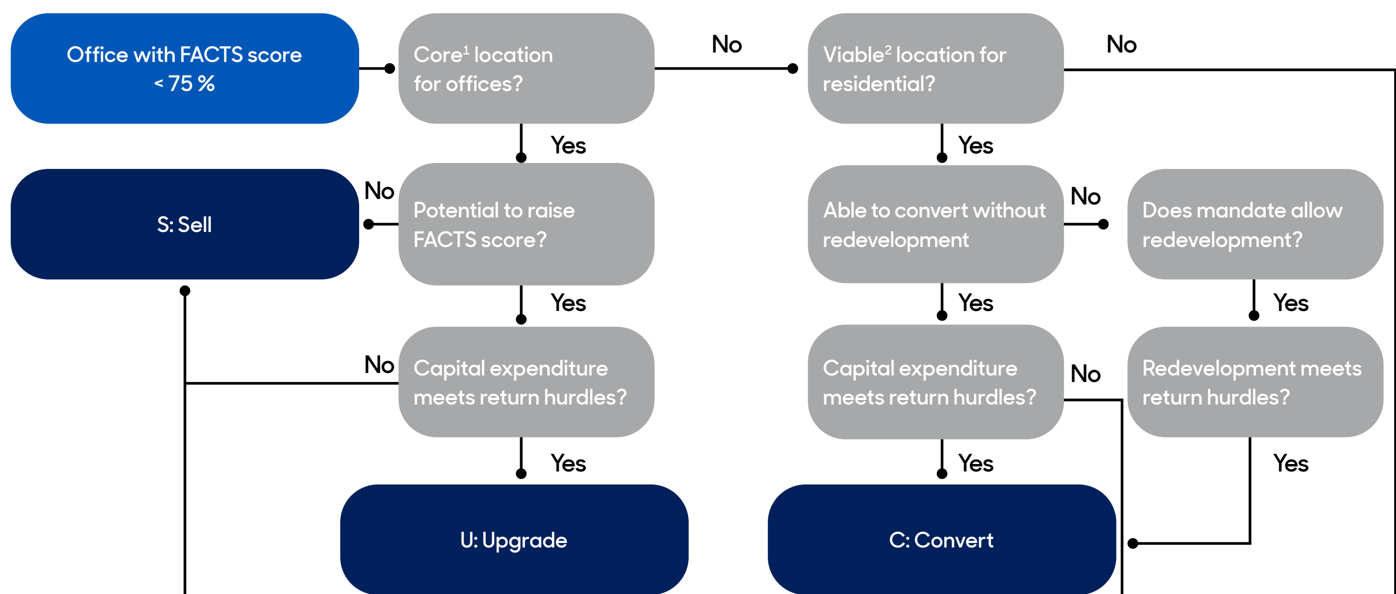

Source: MSCI-IPD, abrdn; April 2023.

# What do we do with non-FACTS-fit offices?

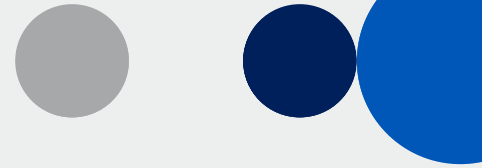
The key follow-up question for investors would be: what do we do with offices that score poorly under the FACTS framework? One way to think about this would be via a sell, upgrade or convert screen (or SUC-S – Chart 5), which describes a decision flow like this:

- **Firstly, can the asset be upgraded?** Offices that score well in terms of location – high scores for A (amenity) and C (connectivity) – but still have an overall FACTS score of under 75% (not FACTS-fit by our definition) are prime candidates for consideration. A recent example is the Interchange in Birmingham, UK.
  - Assuming there is potential for refurbishments to raise the subject's FACTS score to 75% and above, the next question is whether the investment required to achieve this will meet return hurdles. In our May 2021 paper, we estimated the cost of a FACTS refurbishment could be around 24% of the initial purchase price. This was based on JLL's estimate that the cost of a refurbishment to achieve net-zero carbon by 2030 could be USD3,150 per square metre, versus USD2,500 for a standard refurbishment. We also estimated a further 10% premium. We believe this remains a reasonable estimate.
  - **If not, then can the asset be converted for an alternative use?** We rank conversion behind an upgrade, principally because we believe it is easier to navigate an upgrade – especially if the building is not fully vacated. In our view, the best alternative use for office assets is likely residential, given the demand for well-located living space.
  - Assuming the location works for residential use (including regulatory factors, such as the ease of obtaining change-of-use approvals), the next question is whether this is a conversion or a tear-down-and-rebuild job. From a cost-and carbon-footprint perspective, a conversion is preferred. According to Gensler, conversions are typically 15-20% less expensive than new apartment buildings, with a faster time to market. In addition, a 12-storey conversion (versus a redevelopment) can prevent 1.5 million kilos of carbon dioxide from being released into the atmosphere. This is equivalent to a jet flying around the world over 100 times.
- **If all else fails – sell.** This could imply exiting the asset at a significant discount. However, our view is that the bifurcation between FACTS-fit offices and those that are not will only increase over time. The sooner investors face the facts (pun intended), the smaller the discount that may be required.

**Chart 5: Sell-Upgrade-Convert Screen (SUC-S)**




Source: abrdn; April 2023.
[1] Core locations for offices include those with high A (amenity) and C (connectivity) scores in the FACTS rating.
[2] Viability includes ease of obtaining planning approvals and permissible zoning for residential use.



# Case study
# Interchange, Birmingham, UK

**Project: Interchange, Birmingham, UK**

Location: 151-165, Edmund Street.

Directly adjacent to Snow Hill railway station, at the heart of the Colmore Business District.

**Before intervention:**

A secondary-grade office asset, with around 65k sq ft of office space over six floors, which was 40% vacant heading into the Covid pandemic.

**The intervention:**

Refurbished part of first floor to category A+ standard 'change-ready' suite for occupation on a flexible basis.

Enhanced common reception area (+35%) and introduced gym-quality facilities for changing and storage.

Replaced gas-driven heating/cooling with fully electric VRF (variable refrigerant flow) systems; achieved WiredScore Platinum status for digital connectivity.

**Key outcome:**

Achieved rents outperformed estimated rates by an average 23%.

Source: abrdn; April 2023.

# Further price adjustments required to incentivise upgrades and conversions

Notwithstanding the pricing adjustments in offices so far, we believe there is room for further corrections to incentivise more FACTS refurbishments or conversions to alternative uses. Consider the following:

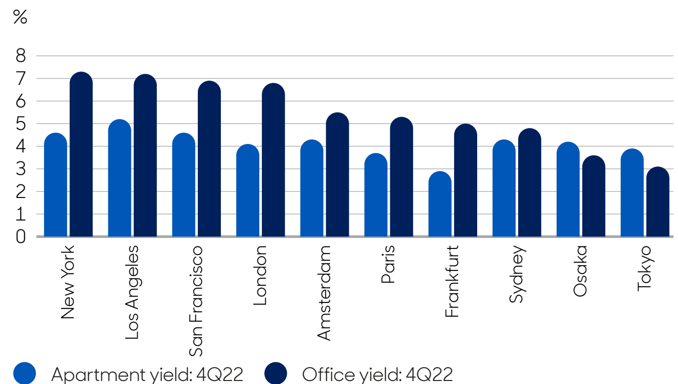
- The average office yield across major cities was 5.6% at the fourth quarter of 2022 (Chart 6). If investors were to target a profit margin of at least 15%, the average yield on cost would need to be at least 6.4% in the case of a FACTS refurbishment. Taking into account capital expenditure (capex) of 24% and a FACTS rent premium of 15%, this would require the entry yield to be at least 7% (25% higher) on our estimates (Chart 7).
- In the case of a conversion to residential use, the required entry yield would need to be even higher. A key reason is that, on a per square foot (psf) basis, residential rents are on average just 40-50% of office rents in similar locations (Chart 8). The average residential yield across the major cities was 4.2% as at the fourth quarter of 2022. Again, assuming a target profit margin of at least 15%, capex of 33% (the cost of conversion from office to apartment is around USD150-200 psf in the US, according to Moody's estimates), and residential rents are 50% of those for offices, this suggests a required entry yield of at least 13% (125% higher).

An important reason as to why office-to-apartment conversions have been more successful in the US could be the smaller difference between apartment and office rents (Chart 8). In fact, a November 2021 study conducted by the National Association of Realtors found that, in the 27 metropolitan areas in the US with the biggest decline in office occupancy, 22 had market conditions that favoured conversions, including higher apartment versus office rents.

Apart from the fact that entry yields would need to be higher to incentivise investments, there are also physical constraints that have made converting office buildings to apartments challenging. Most offices have deep floor plates and tall ceiling heights, which could be either difficult or costly to adapt for residential use. The difference in the requirements and set-up for utilities is another challenging area.

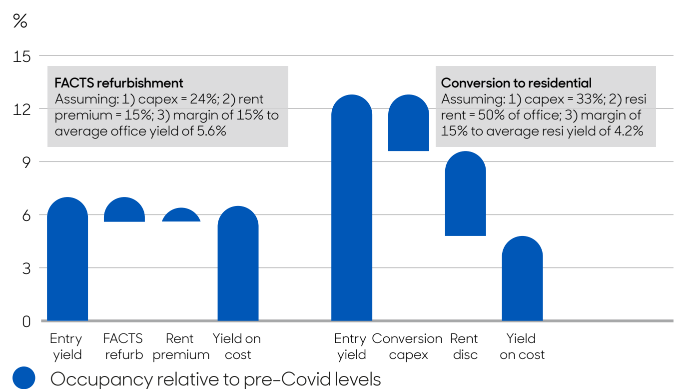
In the next instalment of our papers on the office market, we will focus on some lessons that we have learnt from the experience in the US on office-to-apartment conversions. We believe some of these could be applied in other markets to improve the feasibility of projects.

**Chart 6: Apartment versus office yields in major cities**



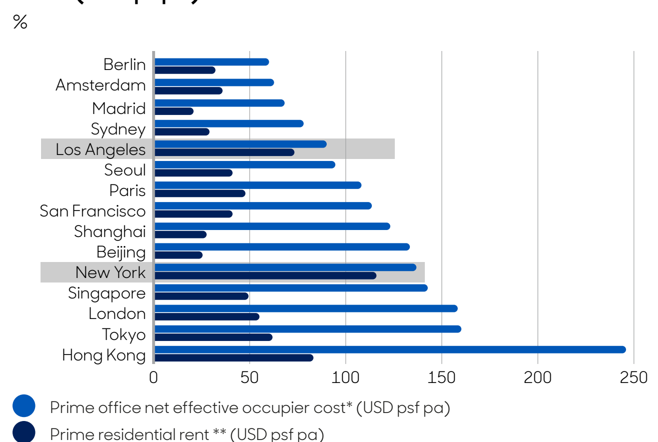

Source: Green Street, JLL, abrdn; April 2023.

**Chart 7: Yield on cost estimates: FACTS upgrade versus residential conversion**




Source: MSCI-IPD, abrdn; April 2023.

**Chart 8: Prime office versus residential rents across global cities (USD pf pa)**




Source: Savills Research, abrdn; December 2022.

* Data from Savills, Prime Office Costs: Quarterly Highlights, January 2023.

** Data from Savills, Prime Residential Index, February 2023.

## Contact details

**Min-Chow Sai**, Head of Asia & NA RE Investment Strategy
+65 6395 2441
**min-chow.sai@abrdn.com**

**Ilyas Mohd Ismail**, Research Analyst,
APAC RE Investment Research
**Ilyas.mohdismail@abrdn.com**

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