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Office REITs – Is Working From Home the Future?

In 1Q2020, the Grade A CBD office in Singapore saw rent slip 0.4% q/q to SGD11.50 psf pm according to CBRE Research. This was the first decline after ten quarters of rental growth. Vacancy rate though has improved to 2.4%. Island wide, rents fell by 0.8% q/q with vacancy rate higher at 11.0% (4Q2019: 10.5%). Looking ahead, the office sector is expected to experience some pain as tenants downsize, put expansion plans on hold and adopt remote working. Non-renewal of upcoming lease expiries, coupled with subdued new demand is likely to lead to higher vacancy rates and lower rents. While natural lease expiries could be the most immediate pain point, the office REITs have single to low double digit leases expiring in 2020. Broadly, we expect these lease maturities to be manageable.

Looming economic recession

While some may argue that we are already in the midst of a recession, we think either way the knock on effects on the office sector are companies (1) downsizing, (2) putting expansion plans on hold, (3) relocate to another place outside Singapore or (4) cease operations entirely. We think these changes could be a result of a weaker operating environment for businesses, topline figures contracting as well as practicing prudence in times of uncertainty. Uber, the U.S. ride-hailing company, for example, is moving out of its APAC HQ at Frasers Tower. That said, Alibaba Group, the Chinese e-Commerce giant has recently purchased a 50% stake in AXA Tower which is across the street from Frasers Tower. Evidently, there are companies who still managed to grow in this difficult time but given the widespread impact of COVID-19, we expect such companies to be the minority.

Two months WFH trial

Since the implementation of the circuit breaker in Singapore on April 7, companies had to make large scale telecommuting arrangements for their office employees. Most companies in Singapore perhaps have never had such a high proportion of their employees work from home for such prolonged period prior to the outbreak of the pandemic. We think the pandemic has unintendedly brought about an eight week long work from home business continuity trial for companies, and both companies and employees alike have much to take away from this exercise. Depending on the sector the company is in and the type of work its employees perform, for some, working from home was always been viable but just not tested. There have been reports and talks on how productivity quickly returned to normal as employees adapt and leverage existing technologies to conduct their daily responsibilities. Specifically, we think knowledge workers and IT firms are most suitable for remote working. In addition, working from home has also allowed working parents to be physically present for their children. We think this is particularly beneficial for working parents with young children.

WFH reduces operating cost for companies

Simply put, having employees work from home is cheaper for companies than work from office. Companies can save on rent, maintenance expenses and other utilities expenses to run the office venue. Should productivity not be compromised, we expect companies to become more accepting of the remote working, and this is especially so after having actually trialed it. This bring about deliberations among management of companies on the value add of office spaces, whether those spaces are worth the cost and whether their companies actually need all of the office spaces they currently have. According to Economic Development Board (published on 11 Feb 2020), in 2018, rental of building and premises made up less than 5% of total operating cost excluding labour cost, material costs and depreciation for the relevant sectors such as Information & Communications, Finance & Insurance, Business Services and Precision Engineering. While the percentage may not be high for a typical office tenant, at a time where all costs are being looked at especially less essential costs, we expect rental costs to be considered as well.

Office spaces exist for good reasons

There are no doubt benefits to having a venue for employees to gather, particularly for roles which requires teamwork and comradeship. Being in a common space allows employees to have spontaneous intellectual exchanges which may spark good new ideas. Also, communication among colleagues is more casual and less effortful. Working from office encourages a lot more contact and interaction relative to working remotely. Therefore, having an office space also allows companies to stay connected to their employees and employees to connect among themselves organically. This can help develop corporate culture and build loyalty which may sum up to greater productivity and innovation. We think the benefits could be longer term ones.

Our View and what it means for office REITs

Working from home is here to stay. The bigger question is to what extend? Will companies be allowing their employees to work from home one day a week? Or two weeks every month? Will it become common practice that companies have a 10-20% of their employees work from home? The risk for office REITs is demand risk stemming from companies evaluating the cost of their office real estate footprint and becoming more comfortable with the concept of remote working. We expect more corporations transit to a hybrid model permanently, with both working from home and working from office capabilities. Such a model can possibly be beneficial for the company in times of economic slump and public health emergencies like the one we are facing today. This shift towards remote working will be structural, and demand for office spaces may go down progressively. At present, we are seeing U.S. corporations step forward to implement permanent work from home for their employees. Some of the names are Twitter, Square, Facebook and Shopify (mostly tech-related companies) while in India new legislations are being mulled to facilitate industry wide move towards working from home for employees in the tech industry. For now, we do not expect this to be the norm in Singapore and we think it is premature to say that office days are over but the office sector will experience some pain as a result. We also expect the lower rent and higher vacancy rate due to lower demand to be manageable for the office REITs. Natural lease expiries could be the most immediate pain point. Overall, the office REITs have single to low double digit leases expiring in 2020. Keppel REIT ("KREIT") has the lowest proportion of leases expiring in 2020 (4.7%) while Suntec REIT ("SUN") has the highest at 13.0%. That said, SUN's 13.0% refers to its Singapore office portfolio which make up ~62% of total portfolio based on portfolio valuation. SUN has retail and convention segments as well as exposures to Australia. Broadly, we expect these lease maturities to be manageable.

2020 Expiring Leases for Office REITs

REIT	Issuer Profile	% of office leases expiring in 2020 based on gross rent	Weighted average lease expiry by NLA in years
CapitaLand Commercial Trust	Neutral (3)	10%[1]	3.7
Keppel REIT	Neutral (4)	4.7%	3.7
Mapletree Commercial Trust	Neutral (3)	~8.0%	2.9
Suntec REIT	Neutral (4)	~13.0%[2,3]	3.3[3]

Source: Company, OCBC (based on latest financial results)
[1]Majority of the leases are under advanced negotiation as per disclosure in April 2020 presentation
[2] Based on NLA instead of Gross Rent
[3]Refers to Singapore portfolio only

Explanation of Issuer Profile Rating / Issuer Profile Score

Positive ("Pos") – The issuer's credit profile is either strong on an absolute basis, or expected to improve to a strong position over the next six months.

Neutral ("N") – The issuer's credit profile is fair on an absolute basis, or expected to improve / deteriorate to a fair level over the next six months.

Negative ("Neg") – The issuer's credit profile is either weaker or highly geared on an absolute basis, or expected to deteriorate to a weak or highly geared position over the next six months.

To better differentiate relative credit quality of the issuers under our coverage, we have further sub-divided our Issuer Profile Ratings into a 7 point Issuer Profile Score scale.

IPR	Positive		Neutral			Negative	
IPS	1	2	3	4	5	6	7

Please note that Bond Recommendations are dependent on a bond's price, underlying risk free rates and an implied credit spread that reflects the strength of the issuer's credit profile. Bond Recommendations may not be relied upon if one or more of these factors change.

Explanation of Bond Recommendation

Overweight ("OW") – The bond represents **better relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Neutral ("N") – The represents **fair relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Underweight ("UW") – The represents **weaker relative value** compared to other bonds from the same issuer, or bonds of other issuers with similar tenor and comparable risk profile.

Other

Suspension – We may suspend our issuer rating and bond level recommendation on specific issuers from time to time when OCBC is engaged in other business activities with the issuer. Examples of such activities include acting as a joint lead manager or book runner in a new issue or as an agent in a consent solicitation exercise. We will resume our coverage once these activities are completed.

Withdrawal ("WD") – We may withdraw our issuer rating and bond level recommendation on specific issuers from time to time when corporate actions are announced but the outcome of these actions are highly uncertain. We will resume our coverage once there is sufficient clarity in our view on the impact of the proposed action.

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