



OFFICE: WFH and *maybe* coming back

NOVEMBER 2022



SESIKILE CAPITAL
Property Investments

T +27 11 684 2681 | E info@sescap.co.za | W www.sesfikilecapital.com

2nd Floor, 18 The High Street, Melrose Arch, Johannesburg, South Africa, 2076

Sesfikile Capital (Pty) Ltd is an Authorised Financial Services Provider. FSP number: 39946



Date: 30 November 2022

Earlier in November, we saw announced layoffs from tech businesses Meta (Facebook), Amazon, Twitter, Salesforce, and many other smaller businesses totaling around 120,000. This is above the 107,000 recorded in the 2000-01 "dot-com" crash era. Added to this are widespread hiring freezes in the financial services sector, with Goldman Sachs expecting to retrench hundreds of bankers. Given heightened expectations of a recession in the US, Europe, and the UK, it is fair to assume that job losses will likely accelerate and spread to other unrelated sectors.

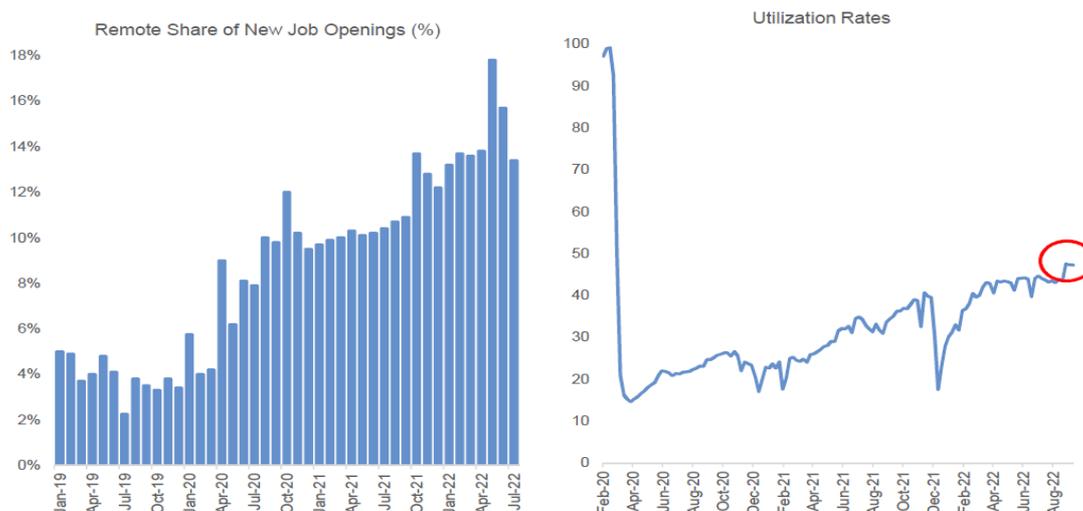
This brings our concerns around the office sector into focus, where the starting point is concerning: Global office vacancy rates average an already high 14%, and range between 15-21%¹ in key US cities such as San Francisco, Los Angeles, Washington D.C., Boston, and New York. Other gateway cities, such as Sydney and London, have reported vacancy rates of 12.9% and 8.1%, respectively. In the US, Q3 2022 saw 1.1m sqm (around 9 Sandton city malls) of negative net space absorption, while sub-leasing space rose 7.6% to a new record of 17.2m sqm. We have also seen tenant incentives via rent-free periods, tenant installations, or deposit waivers increase while face rents stay flat, resulting in lower net effective (incentive-adjusted) rents.

To add to this, Chart 1 below depicts that despite Covid-19 lockdowns being a thing of the past in most major economies (except for China), the US workforce has not returned to the office in any meaningful way. They have chosen to work-from-elsewhere about 53% of the time. Furthermore, although lower than the April 2022 peaks, a much higher proportion of jobs offer remote working to attract talent. Simply put, people were allowed to work-from-home, and didn't quite come back!

¹ JLL, Dexu



Chart 1: Remote job openings slightly down, and workers still staying home



Source: JP Morgan, JLL, Lightcast as at July 2022, Kastle as of Sep 2022

With share prices down c.35% year-to-date for Office REITs (c.9% lower than global REITs), returns have largely reflected this dire situation. Assuming no rental growth, implied net income yields in European (including the UK) and US REIT portfolios have priced in 90bps to 250bps² in cap rate expansion, respectively. Stated differently, the market believes values could fall 17% to 30% over the next 12 to 18 months. Valuation declines of this magnitude could see a few REITs breach loan covenants, thus forcing dividend cuts, forced disposals, and dilutive capital raises. Management teams will also be challenged to pay greater incentives to tenants while trying to meet green building regulations to avoid obsolescence.

On this basis, we argue that the sector lacks a positive catalyst going forward despite the 'pain' being priced in. With a challenging global economic outlook for 2023 and rising interest rates, things could get a little worse before they get better.

Kundayi Munzara

Portfolio Manager, Sesfikile Capital

² Greenstreet, Bloomberg