For the future you're after

The Irish office market: Back to the office, but not as we know it

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Executive Summary

While the death of the office has been greatly exaggerated, the structural changes impacting the office market have not. Work-from-home ('WFH') and environmental, social and governance ('ESG') requirements are the key structural drivers of change, although ESG is likely to have the more lasting impact. In terms of WFH, and in particular hybrid-working, we believe the pendulum will ultimately swing back in favour of more office use, albeit not exclusively. That is, flexibility in working patterns will likely be an enduring feature of the workplace but with a greater emphasis on the use of the office.

These structural changes have caused a demarcation in performance between prime, good secondary and the rest of the office market. We believe these demarcation pressures will continue in the Irish office market for the foreseeable future. That is, one market where a recovery in occupier demand will face limited new supply, which should result in lower vacancy and ultimately rental growth. In contrast, some parts of the office market may struggle to attract occupier or investor interest.

Since mid-2022, the market has also been impacted by rising interest rates which have contributed significantly to the decline in office values over this time period. It does appear, however, that the interest and inflation cycles have turned, with markets expecting a significant easing in monetary policy between now and early 2025. This has already manifested itself in a sharp fall in bond yields and swap rates since October 2023.

- The Irish office sector has seen capital values fall by 17% in the 12 months to December 2023 and is down 26% from its peak in March 2020. Apart from the global financial crisis in 2008 ('GFC'), the magnitude of the decline to date is at the upper end of the declines the market has experienced in the past.

- The current downturn looks reasonably mature based on capital value declines, duration of downturn, increase in office yields and yield spread over government bonds. A characteristic common to all four previous cycles since 1985 is that the trough in the office market cycle coincided with a sharp decline in underlying economy-wide inflation, with 10-year bond yields ultimately falling as well. These trends in inflation and bond yields became increasingly evident in the last quarter of 2023.

- However, the true depth of the downturn will only be confirmed once liquidity in the Irish office market improves, and increased levels of transactions occur. Increased transactions will provide actual valuation levels and these will confirm or otherwise whether the current cycle is indeed near a trough.

- The top three sectors with the highest incidence of WFH rates in the United States (US) are information and communication technology (ICT), finance and professional services, sectors that the Dublin office market is particularly exposed to. However, these sectors, in particular the ICT sector, are growth oriented which should help mitigate the WFH impact on the Dublin office market over time, given existing clustering effects and Ireland's ability to attract foreign direct investment (FDI).

- WFH arrangements and the effect they have on overall productivity remain a complex and evolving issue, influenced by a multitude of factors, including individual work styles, task requirements, organisational culture, and managerial practices.

- WFH rates will continue to differ sharply across industries, occupations, cities and worker education levels. A notable factor that influences the rate of WFH is the daily commute. For example, cities in the US with the longest commuting times to the office are highly correlated with high incidences of WFH and low levels of office occupancy. Cities with shorter commuting times tend to have higher office occupancy and lower vacancy. Many European cities, Dublin included, have shorter commuting times than many of the major US metropolitan centres and this should help to mitigate the impact of WFH on office occupancy and vacancy in these markets.

- One corollary is that an economic downturn concentrated in remote-intensive sectors could lower the overall WFH rate. A key test of WFH (whether fully remote or hybrid) will be when an economic downturn occurs and the impact that it will have on office attendance.

- The impact of WFH on the office market is still evolving. However, we believe that the pendulum is starting to swing back to greater office use. Nevertheless, it will take more time and data to assess the ultimate impact.

- Speculative office development has been held in check in the Irish market and this has helped to ensure that new supply has never run too far ahead of underlying demand. In fact, the future supply estimates are likely to be overstated as some developments may be mothballed.

- The Irish and Dublin office markets are characterised by a very limited amount of energy-efficient office space. A total of 89% of Ireland's office stock has a building energy rating (BER) rating of C or lower. The 2025 Realignment of Energy Performance Certificate (BERs in an Irish context) requires public buildings and all commercial buildings to have a minimum performance of E or better by 2027 and a minimum performance of D or better by 2030 (i.e. approximately 6,000 buildings in the office sector alone). In reality, many of the offices in the C and D categories would need to achieve a minimum of a B rating in order to be lettable in the future. One of the key issues is funding this transition.

- Limited availability of Grade A space has seen prime headline rents increase and consolidate at under €700 per sq.m. per year, but a drop-off in take-up and increased supply is likely to see rents soften over the coming year. However, any correction is expected to be reasonably modest given the limited amount of new supply and an expected recovery in occupier demand. This confluence of events could result in a supply/demand imbalance in the prime end of the market from late 2024 onwards.

- This could lead to an even greater demarcation between prime, good secondary and the rest in terms of rents and yields. However, this demarcation is necessary in order to spur either new development or, more importantly, the redevelopment/refurbishment of existing stock.

- Dublin office vacancy is expected to peak at rates in the high teens in 2024, which is likely to put additional pressure on rents. However, Ireland has a high natural vacancy rate, with estimates in the range of 11%, which means that the excess supply is not as significant as it may first appear. True excess supply is in the region of 220,000 sq.m., which equates to approximately one year's take-up in the office market.

- The estimated level of overvaluation in the office sector has declined in recent quarters on the back of continued resilience in the Irish macroeconomy. In fact, the Irish office market appears to be fairly to slightly undervalued based on our model estimates. However, markets generally undershoot their fair value before a recovery ensues and thus some further downside is likely in the market in the short term.

Overview of the Dublin office market

The Dublin office market, which stood at circa 4 million sq.m. of space at the end of 2023, is by far the dominant office market in Ireland.

Dublin's attractiveness as a city for doing business on a global scale is well documented, with the city hosting a major international presence, particularly in the Docklands and wider Dublin 2 sub-market.

Global players such as Google, Meta, and LinkedIn all have their European headquarters in the city, while a number of international financial institutions also maintain a large presence.

This is especially notable given the size of Dublin's office market compared with its European peers.

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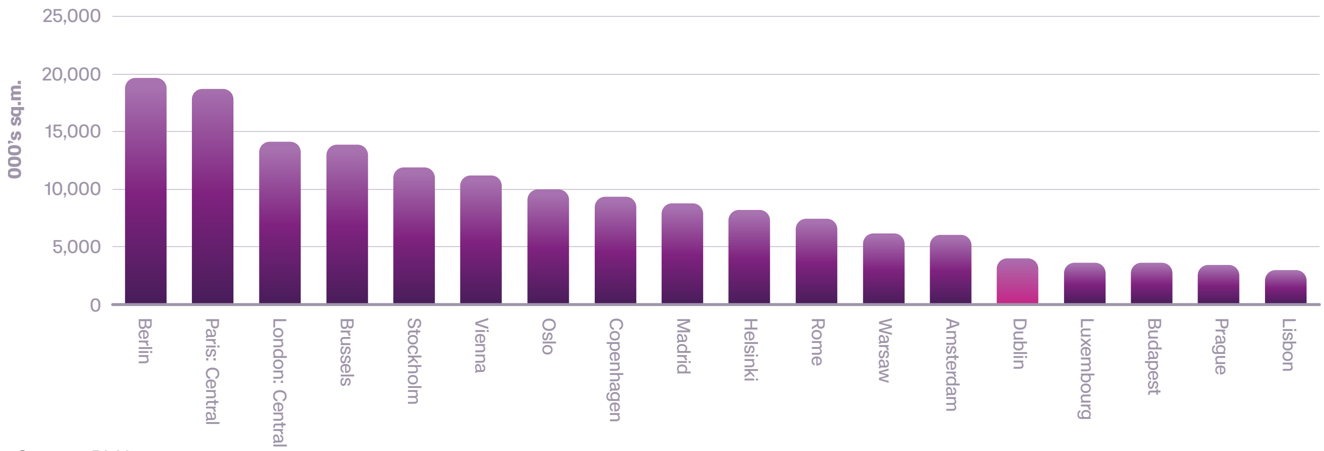
European capital city office stock, '000 sq.m, net, end 2022



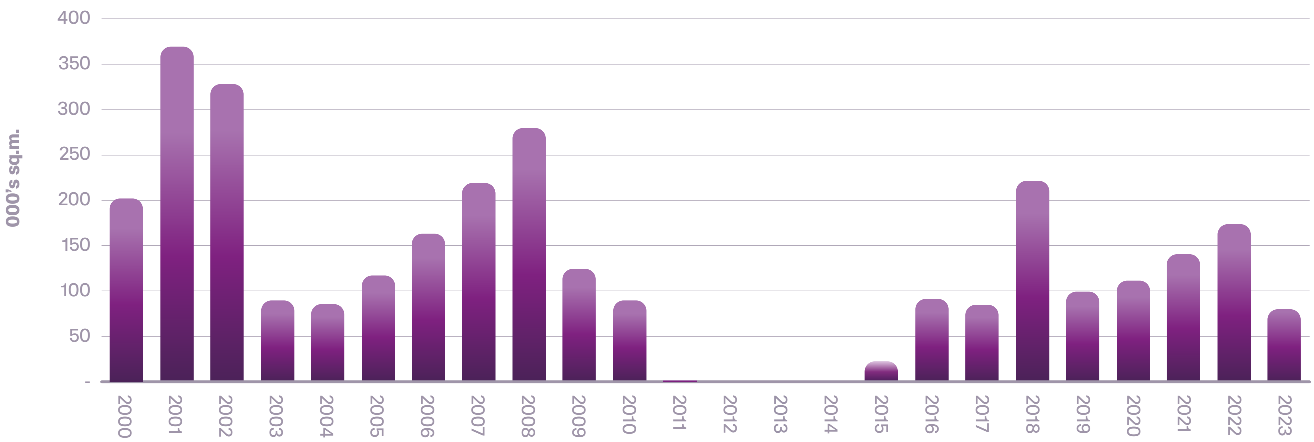
Source: PMA

Dublin – a relatively small office market

Based on an analysis of office markets in other European capital cities, Dublin comes in at the lower end of the scale in terms of space. The Dublin market is around a third the size of that in Vienna, a city of under two million people, while it is around one quarter of the size of the Brussels market.

This is despite a number of years of strong office building activity, although it should be noted that between 2011 and 2015 there was little to no new stock added in Dublin. Also, despite office construction picking up over the last number of years, following an extremely strong 2018, the scale of building is relatively constrained, with very little speculative stock being built.

Dublin office completions - 000's sq.m., net



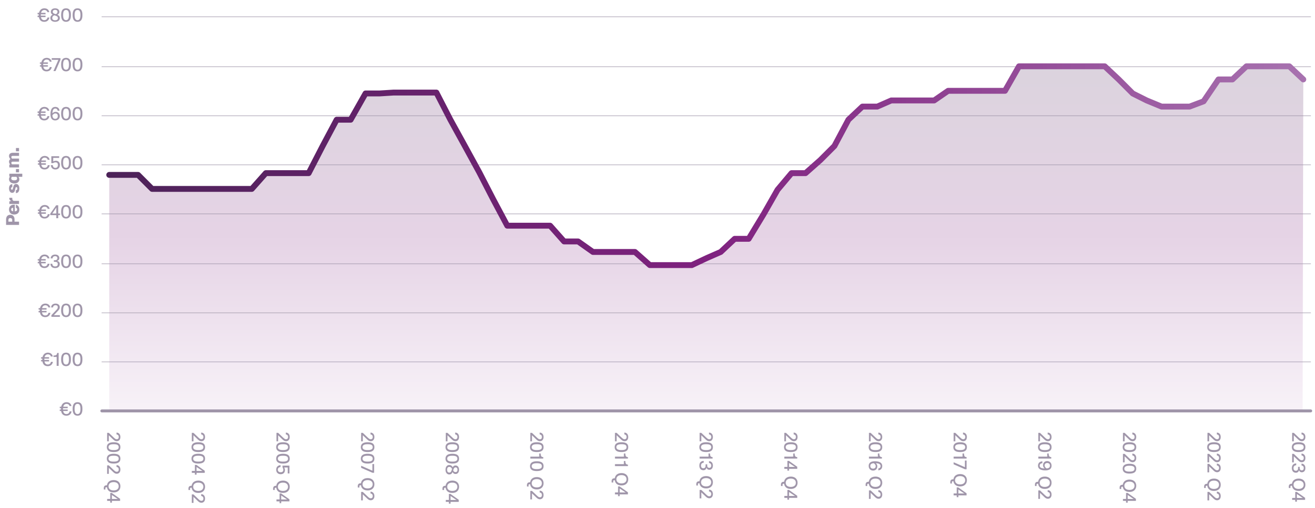
Source: PMA

Some, but limited speculative supply

As a result of supply being relatively constrained, prime rents in Dublin have held up reasonably well, and are now back to pre-COVID-19 pandemic levels. However due to the rising vacancy rate and slower levels of leasing activity, prime Dublin office rents reduced from €700 per sq.m. at the end of Q3 2023 to €673 per sq.m. at year end.

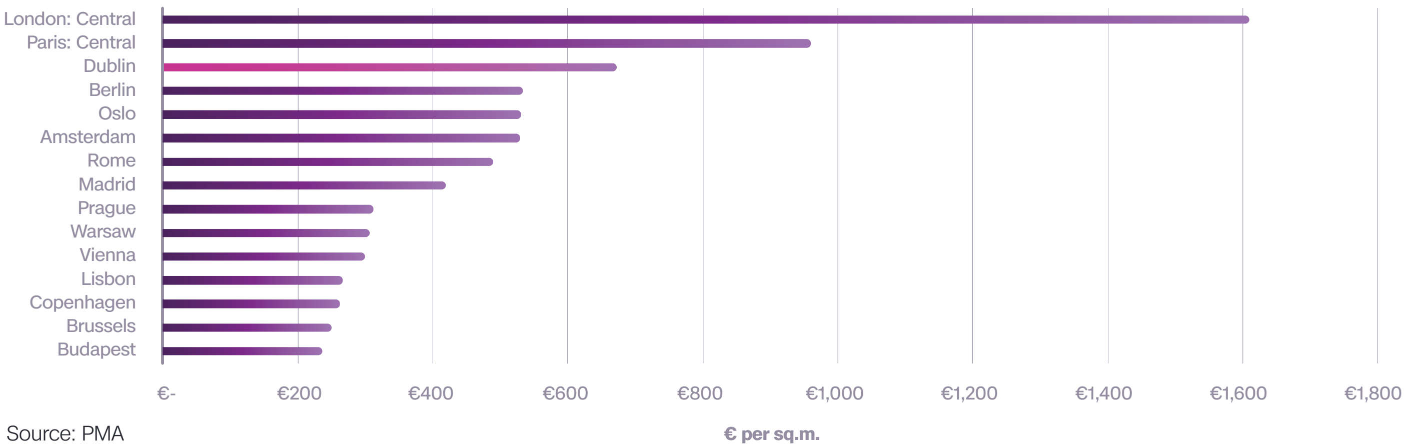
This places Dublin prime rents in the upper echelon of European rents. Furthermore, it reflects the relatively small size of the Dublin market, (in particular the prime/ super prime end of the market), combined with Ireland's ability to attract strong flows of FDI.

Dublin office prime rents (€ per sq.m.)



Source: CBRE

European office prime rents Q4 2023 (€ per sq.m.)

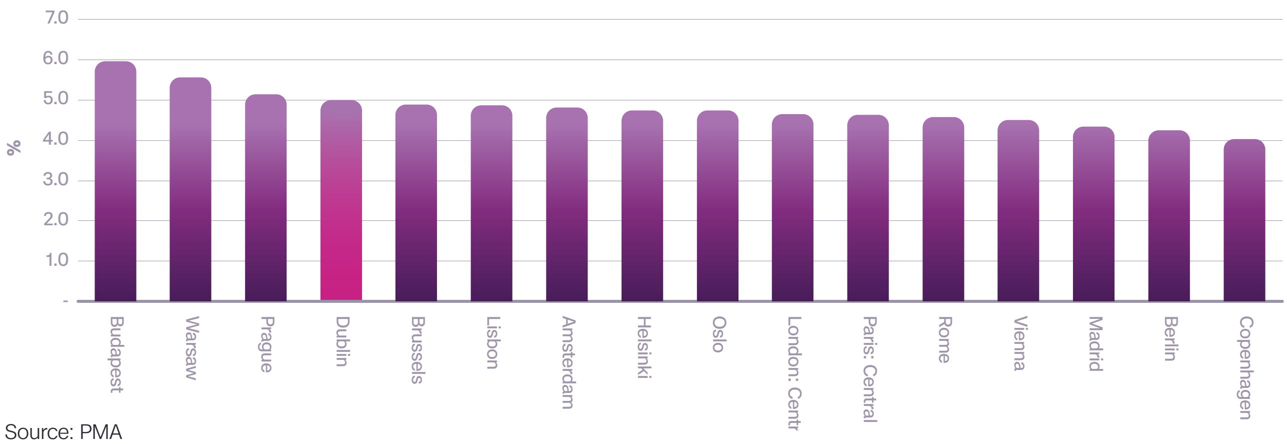


Source: PMA

Outside of this prime segment however, rents are coming under downward pressure and this is also being reflected in increased incentives, such as rent-free periods. At the end of Q4 2023, CBRE was quoting rents in the South Suburbs at €318 per sq.m., and €221 per sq.m. in the North suburbs.

Prime yields also remain relatively attractive in a European context, having moved outwards by 100 bps since before the COVID-19 pandemic, to now stand at c.5.00%.

European prime office net yields (%) Q4 2023



Source: PMA

We are likely to see continuing divergence between the prime segment of the market, which comprises the most modern and high-quality stock, and the secondary segment, much of which is older stock and will likely be subject to retrofitting requirements as ESG becomes increasingly important. This divergence will be discussed in more detail later in this report.

Subdued volume of office take-up

In terms of occupier activity, the most recent data published by Lisney show that take-up in 2023 was approximately 120,000 sq.m., less than half the previous 10-year average of 243,000 sq.m.

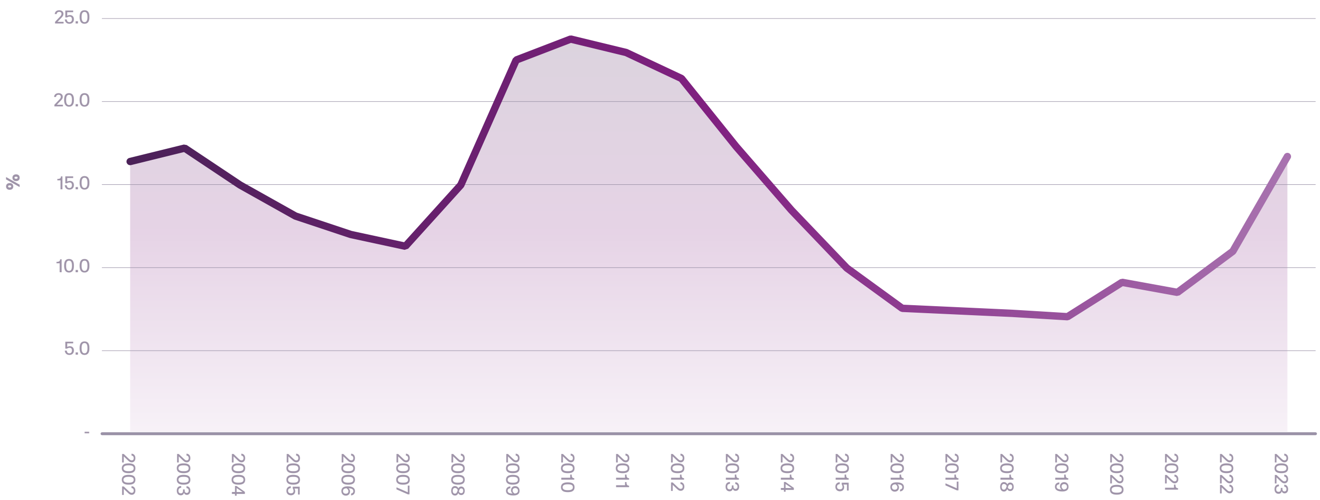
Despite the well-documented slowdown in the technology sector, it still accounted for the largest share of office take-up in 2023, with technology companies accounting for 24% of space taken in the year.

The office vacancy rate stood at 16.7% at the end of the 2023, up from 10.9% a year earlier. The rate is likely to increase further in 2024.

This leaves Dublin's vacancy rate among the highest in Europe when compared with other major capital cities, although it also includes so-called grey space, that is space which is being sublet by occupiers. Grey space accounted for 26% of take-up in 2023, and CBRE expects this trend to continue as tenants choose ready-to-go space over having to incur capital expenditure on fit-outs, while also favouring the flexibility that grey space offers as they wait to decide on longer-term options.

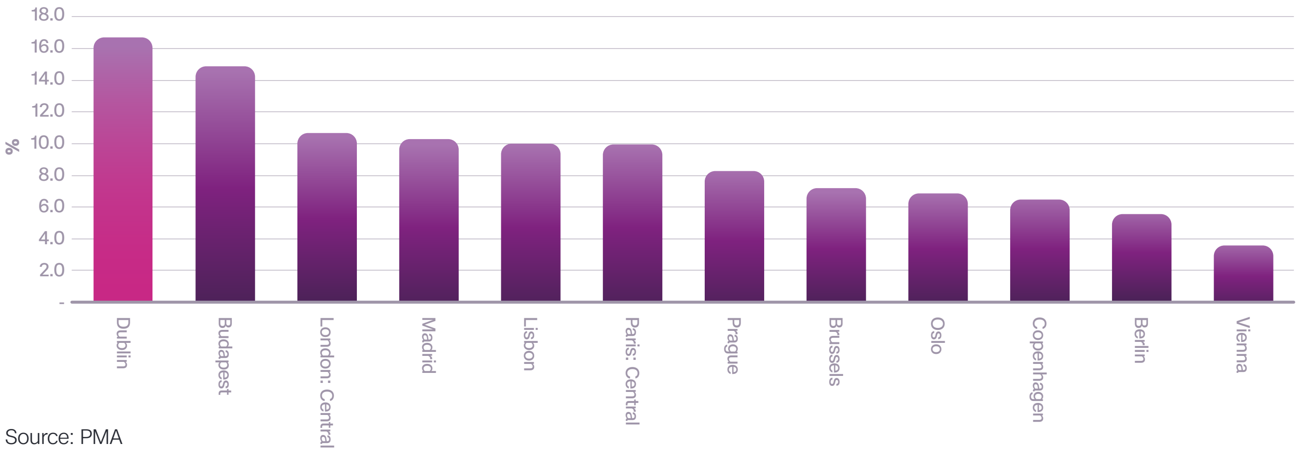
It has been estimated that the Dublin office market has a higher natural vacancy rate than many of its European peers. The natural vacancy rate is estimated to be in the range of 11%, which means that the excess supply is not as significant as on first impressions. True excess supply is in the region of 220,000 sq.m., which equates to approximately one year's take up in the office market.

Dublin office vacancy (%)



Source: PMA

European office vacancy Q4 2023 (%)



Source: PMA

According to CBRE, total demand requirements stood at more than 235,000 sq.m. of space at the end of 2023, which is close to the 10-year annual average take-up of 240,000 sq.m., indicating that the Dublin office market is holding up well in challenging times for office markets around the world.

Despite the well-documented challenges faced by office markets, there are a number of factors which leave Dublin in a relatively favourable position.

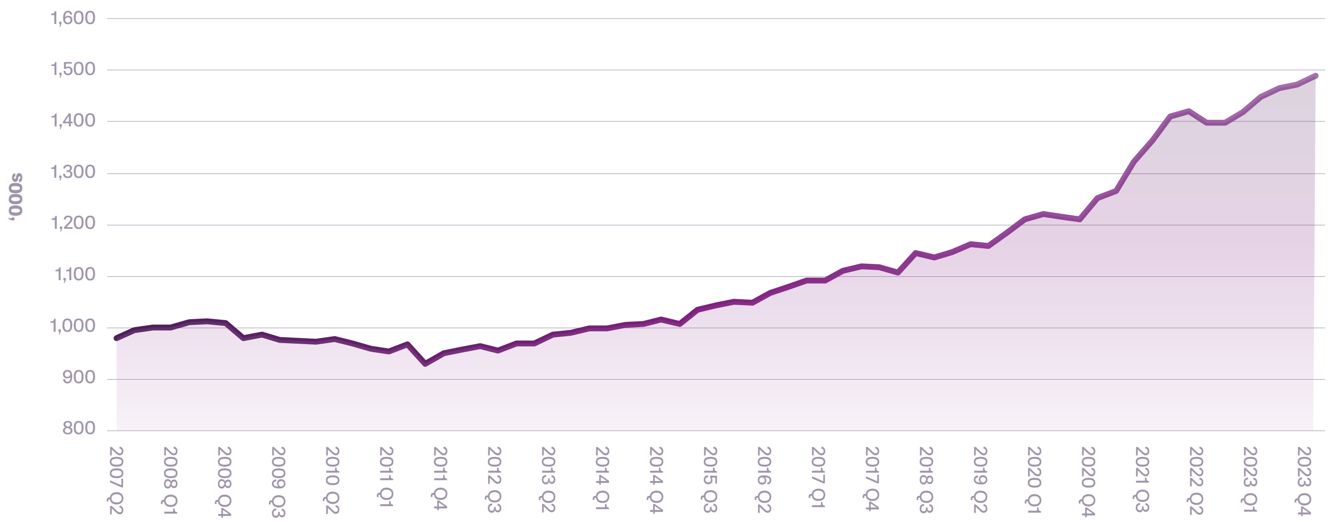
The presence of major global firms has positioned Dublin as a well-established centre for business and consequently office-based activity, and as a result it is likely that the city will remain attractive both for existing occupiers looking to expand their footprint and new entrants to the market aiming to take advantage of existing knowledge spillovers and the availability of an international skilled workforce.

Irish office-based employment[1] also continues to rise, standing at almost 1.5 million workers at the end of 2023, according to Central Statistics Office (CSO) data.

While there has been a shift to hybrid working across the market, any increase in the number of people whose jobs are based in offices ultimately underscores demand in the office market.

[1] Derived from the sum of CSO employment data for the following categories: Managers, directors and senior officials; Professional occupations; Associate professional and technical occupations; Administrative and secretarial occupations.

Irish office-based employment ('000s)



Source: CSO

Valuation estimates of the Irish office market

Office valuations tend to co-move with the macroeconomy since variables such as economic growth, consumption and employment levels tend to have a strong bearing on Commercial Real Estate (CRE) property demand. Consequently, estimating office property values relative to these macroeconomic variables can provide some indication on the relative over/undervaluation of the office market. Additionally, viewing office property values as the sum of future discounted cashflows can also provide a sense of where fundamental values lie when assessing current rents and initial yields.

The following chart shows the estimated over/under valuation in the Irish office sector based on a model we developed to track the relative valuation of the market. The model itself is a function of a number of subcomponents and includes:

- Future cashflow estimates such as the deviation of the Irish office capital value-to-rent ratio from its historical average and the deviation of the office and 10-year bond yield spread from its historical average.
- Macro factors such economic growth, employment and overall level of consumption.

Valuation estimate of the Irish office market

From June 2022, capital values in the sector (according to these components) were estimated to be overvalued to the tune of 15%. However, given the large decline in capital values observed since June 2022 in the sector, capital values are now estimated to be in undervaluation territory when considered using these indicators.

The estimated level of overvaluation in the office sector has declined in recent quarters on the back of continued resilience in the Irish macroeconomy, with the model indicating that the office market is entering slight undervaluation territory. The primary driver is the strength of the underlying economy, while the property fundamentals themselves, such as yields and rents, are still pointing to a slight overvaluation. However, combining both sets of factors (the macro and future cashflows) together suggests that the market is no longer overvalued.

However, it should be noted that while the model can provide important insights into office capital values, it is subject to a number of caveats:

- Firstly, small sample sizes make it difficult to pin down 'average' values for the indicators, making them vulnerable to structural changes.
- Second, data limitations make it difficult to incorporate other factors relevant for valuations such as commercial property supply elasticity.
- Third, office values may reprice much faster than the underlying macroeconomic variables.

Irish office market cycle – the current downturn in historical context

The Irish office sector has seen capital values fall by 17% in the 12 months to December 2023 and is down 26% from its peak in March 2020. Apart from the GFC period, the magnitude of the decline to date is at the upper end of the declines the market has experienced in the period 1984 to 2008. While technically the market peaked in Q2 2020 (according to MSCI data), much of the decline has been concentrated in the period from June 2022 to date – coinciding with the start of European Central Bank (ECB) monetary policy tightening.

Since 1984, there have been five periods (including the current downturn) when the Irish office market has experienced multi-annual declines in terms of capital values, as can be seen in the following chart.

Continued resilience in the Irish macroeconomy has contributed smaller overvaluation pressures

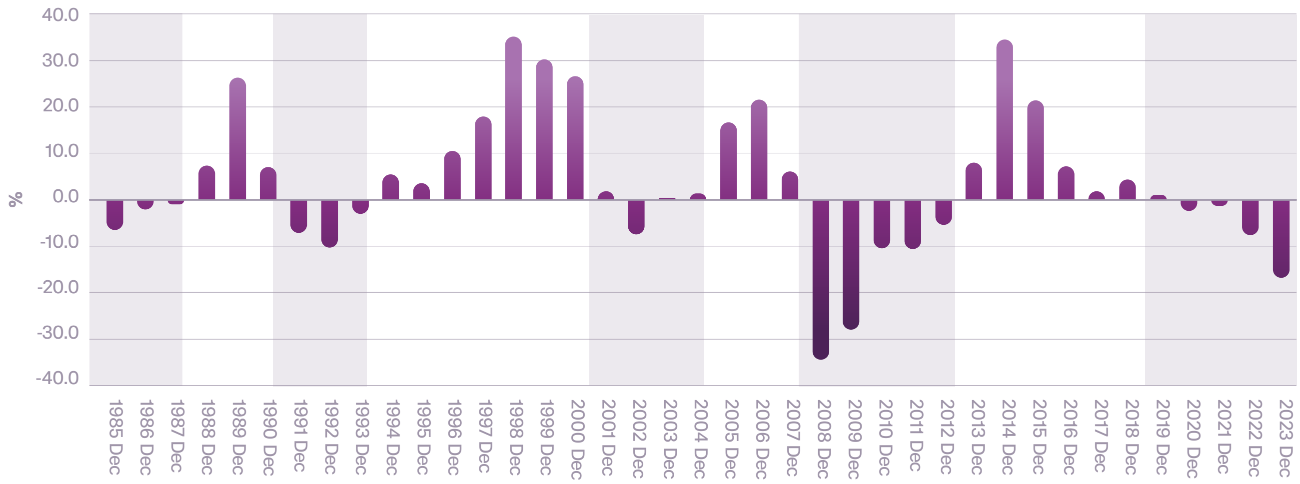
Source: AIB

Irish office – a relatively volatile asset class

To put the current downturn in an historical perspective we compare it with these multi-annual declines. The accompanying table on the next page summarises the key characteristics of these multi-annual downturns in terms of:

- The magnitude of the downturn.
- The duration of the downturn.
- The change in (equivalent) yield from the peak in the market to the trough in the market.
- The change in Irish inflation from the start of the respective cycle to the end of the respective cycle.
- The change in Irish 10-year bond yields from the start of the respective cycle to the end of the respective cycle.
- The change in the yield spread between office yields and bond yields from the start of the respective cycle to the end of the respective cycle.

MSCI Irish office capital growth – Annual % change



Source: MSCI

Key characteristics of the multi-annual downturns in the office market

	Decline	Duration	Office Yield (Cycle Low)	Office Yield (Cycle High)	Inflation (Annual Average Start)	Inflation (Annual Average End)	10 Year Yield (Start)	10 Year Yield (End)	Yield Spread (Start)	Yield Spread (End)
1984-87	-9.40%	36	7.30%	8.10%	8.60%	3.20%	15.10%	10.60%	-780bps	-250bps
1990-93	-19.20%	36	6.90%	8.60%	3.20%	1.50%	10.20%	6.40%	-330bps	220bps
2001-03	-8.70%	24	5.60%	6.40%	4.90%	3.50%	5.20%	4.10%	40bps	230bps
2007-12	-64.50%	63	4.30%	9.00%	4.90%	1.70%	4.30%	4.70%	0bps	430bps
2020-to Jan'24	-26.2	45	5.30%	6.70%	0.3%*/ 7.80%	6.30%	0.30%	2.45%	500bps	425bps

*0.3% was the average rate of inflation in 2020
7.8% was the average rate of inflation in 2022
Source: MSCI, CSO and Bloomberg

Office market cycle in context

The decline in Irish office values that occurred during the GFC was exceptional, both in terms of its own historical performance and compared with its peers at the time. According to MSCI, the capital value of the Irish office market fell by 64.5% and lasted approximately 63 months – one of the steepest and longest declines ever for a developed market. In contrast, between 1984 and 2007, there were three multi-annual downturns in the Irish office market, with declines of 9.4% in 1984–1987, 19.2% in 1990–1993, and 8.7% in 2001–2003. The duration of these declines ranged from 24 months (the 2001-2003 decline) to 36 months (both the 1984-1987 and 1990-1993 declines).

The current peak-to-trough decline of 26.2% makes it one of the steeper declines the Irish market has experienced. While the Irish market did register modest capital declines in the latter half of 2020 and in 2021, in reality it treaded water from the second half of 2020 up to June 2022. The downturn began in earnest in June 2022 and thus the pace of the decline has been quite intense in the period June 2022 to January 2024.

Increase in property yields – substantial in current period

Focusing on the three downturns in the office market prior to the GFC, the average increase in net equivalent office yields was 110 basis points (and 200 basis points if the GFC downturn is included). In the 1984-1987 downturn, equivalent yields rose by 80 basis points to stand at 8.1%. In the period 1990-1993, equivalent yields rose by 170 basis points to stand at 8.6%, and in the period 2001-2003, equivalent yields increased by 80 basis points to 6.4%. The GFC period was an outlier with yields rising by 470 basis points to stand at 9.0%. The low for equivalent yields in the current official cycle was 5.3% around June 2023. Between June 2023 and January 2024, equivalent yields have risen by 140 basis points to 6.7%.

Falling inflation and bond yields generally a precursor to recovery

A characteristic common to all four previous property market cycles is that the trough in the office market cycle coincided with a sharp decline in underlying economy-wide inflation, with 10-year bond yields ultimately falling as well. On average, in previous cycles, inflation fell by close to 300 basis points from the start of the office market downturn to the end, while the average fall in 10-year bond yields was 225 basis points.

The overarching link is that declining inflation facilitated a fall in government bond yields which in turn supported lower yields (and higher capital values) in the office market. While inflation trends in the Irish market are still important for the local commercial real estate market, the key driver of monetary policy and hence bond yields is Eurozone-wide inflation. Consequently, falling inflation and falling bond yields are likely precursors to a sustained recovery in commercial real estate values in general, and office capital values in particular. It does appear that the inflation and interest rate cycles are turning a corner, with significant declines occurring in Q4 2023. If these declines can be sustained, then the foundations for a recovery in bond and office yields would be in place.

Substantial inflation adjustment required

Eurozone headline inflation fell to a recent low of 2.4% in November 2023 (but edged up to 2.6% in February 2024), having reached a peak of 10.6% in October 2022. Core inflation has also continued to decline and stood at 3.1% in February 2024. It has gradually fallen from its March 2023 peak of 5.7%. Irish inflation, based on the Consumer Price Index (CPI) has also decreased, standing at 4.1% in January 2024, down from its peak of 9.2% in October 2022[2].

Inflation adjustment in context

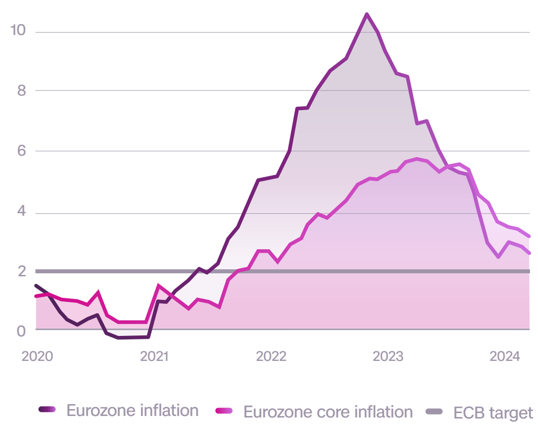
In the current cycle, the required adjustment in inflation will likely surpass the average of previous cycles. Therefore, headline inflation is likely to have to decline by around six to eight percentage points in order to enable the easing of monetary policy and the moderation of long-term interest rates. However, as mentioned earlier, eurozone headline inflation has already decelerated sharply and is likely to meet this requirement in the coming months. Irish inflation is expected to follow suit, albeit with a lag.

The market consensus is that eurozone inflation rates will converge towards central bank targets in 2024. The ECB also expects inflation to decline significantly over the course of 2024, albeit not at the pace the markets expect. The core rate is the ECB's key target rate of inflation with the goal of achieving a 2% annual inflation rate.

Against the backdrop of rapidly declining inflation in the eurozone and weak underlying economic growth, the markets are expecting sharp rate cuts in 2024. They see rates being reduced by approximately 100 basis points in 2024, with a further 25 basis points cut priced in for 2025.

Eurozone inflation has fallen closer to the ECB's target

Harmonised index of consumer prices (annual % change)



Core inflation forecasts

2023	5.0%
2024	2.7%
2025	2.1%
2026	1.9%

Source: Eurostat

[2] The Irish Harmonised Index of Consumer Prices ('HICP') has also fallen sharply from its peak of 9.4% in October, 2022 to stand at 2.5% In November, 2023.

Bond yields and property yields – a key relationship

Government bond yields, in particular 10-year bond yields, are a fundamental benchmark for the valuation of other asset classes, including commercial real estate, and for office markets. The yield spread/ risk premium between office yields and the relevant 10-year bond yield is a key indicator in assessing the relative valuation of office properties. The wider yield spread between office yields and bond yields (where office yields are higher than bond yields), results in a higher risk premium for offices. In general, this indicates a greater valuation buffer for offices. However, when the yield spread narrows and the risk premium falls this results in the valuation buffer diminishing.

Irish 10-year government bond yields reached a high of 12.5% in July 2011 during the GFC and fell significantly thereafter. Irish office yields followed a similar trajectory in the immediate aftermath of the GFC, peaking at around the same time (net equivalent yields peaked at 9% and net initial yields peaked at 10.5%) and fell sharply in the following years. However, while 10-year bond yields fell to a record low level of -0.3% in December 2020, the decline in office net equivalent yields levelled off in 2017/2018 at yields ranging from 5.3% to 5.6%. Office net equivalent yields essentially remained at these levels until March 2022 according to MSCI data[3].

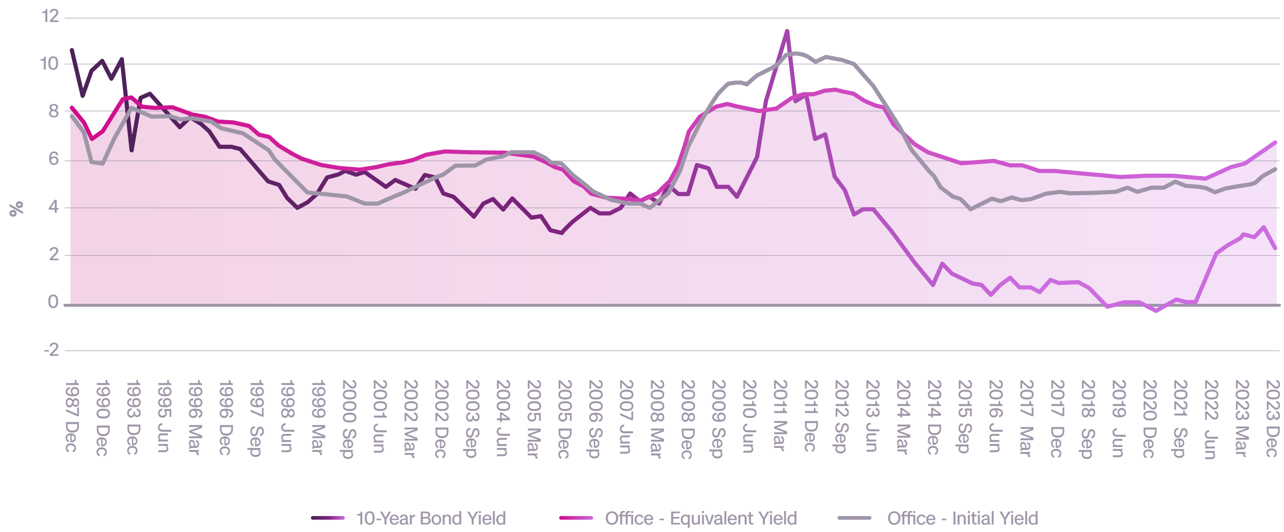
[3] By way of reference, between 2019 and 2022 Irish office net initial yields averaged close to 4.8%. It should be noted that the best-quality, prime offices in Dublin did see initial yields decline further and reached a trough of close to 3.75%.

Irish office yields did not blindly follow government bond yields over the past decade

The divergence of office net equivalent yields from bond yields which started in 2017/2018 resulted in a substantial yield spread or risk premium for office investments. This yield spread, which remained stable at approximately 500 basis points between 2017 and 2021, was one of the highest on record. As a consequence, the office market had a considerable safety buffer when bond yields resumed their upward trajectory in 2022. This enhanced resilience enabled the office market to better withstand the impact of rising bond yields, preventing a more severe decline in capital values when compared with what has transpired since March 2022.

The following chart plots the historical movement of the spread between office yields and 10-year bond yields in Ireland since 1987.

Irish 10-year government bond yield, office equivalent and initial yields

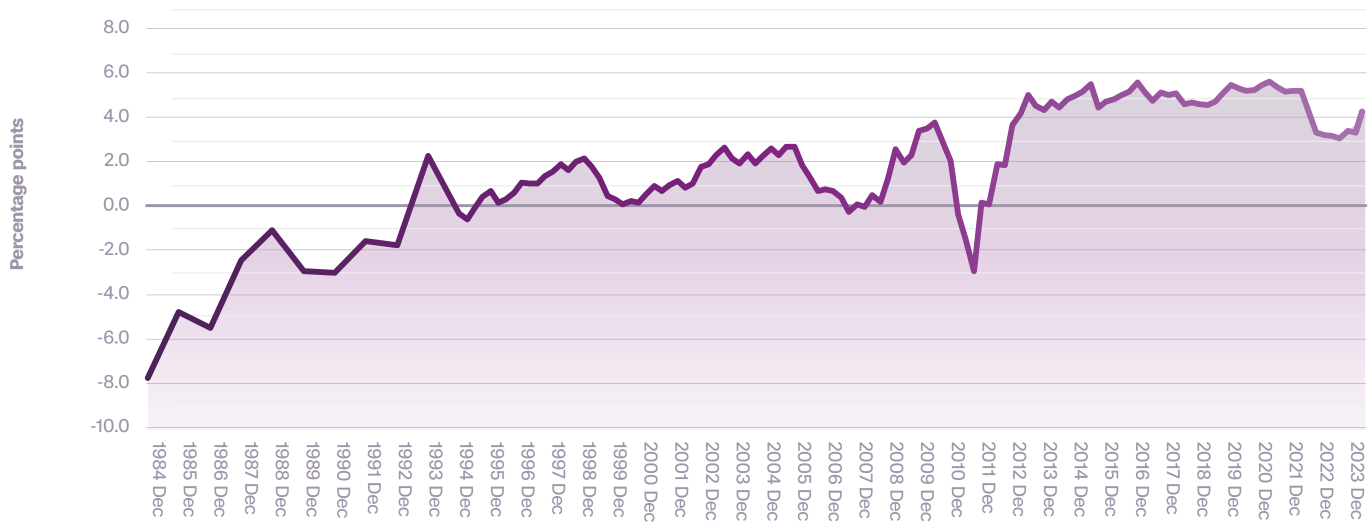


Source: MSCI and OECD

A significant risk premium (yield spread) buffer evident in the Irish office market since 2012

While office and government bond yields have increased since March 2022, bond yields rose at a quicker pace than office yields. This resulted in the yield spread narrowing to approximately 300 basis points in March 2023. Since then, the yield spread has begun to widen as the rise in 10-year government yields began to taper. The yield spread as of January 2024 stood at 400 basis points with office net equivalent yields at 6.5% and 10-year government bond yields at 2.45%. If government bond yields can remain at close to current levels then the current yield spread should be sufficient to start attracting institutional investors back into the office market.

Yield spread between Irish office equivalent yields and Irish 10-year bond yields



Source: MSCI, OECD and AIB

Current cycle very mature

Historical precedent suggests that a significant portion of the adjustment in net equivalent yields has occurred in the Irish office market. However, some further outward movement in net equivalent yields would not be surprising. While rents at the prime end of the market, and to some extent at the upper end of the secondary market, have held up, it would not be surprising to see some softening of rents before the trough of the current cycle. Rents have already declined in other parts of the office market and will likely see some further falls.

It appears that the current office market cycle is mature based on a variety of measures as discussed. While the market may see some further (modest) declines in the coming months, it is likely that the vast bulk of the decline in office values has occurred. However, as we discuss later in the report, this masks what will likely be continued performance demarcation in the office market between prime, good secondary and the rest.

Work from home and the office market

Remote Work in the Post-Pandemic Era: A Double-Edged Sword

Before the COVID-19 pandemic, most workers had limited options when it came to remote work arrangements. However, the pandemic triggered a dramatic shift in the workplace landscape, expanding remote work opportunities, especially for third-level-educated professionals. This newfound flexibility for workers presents a double-edged sword for employers and creates an array of potential opportunities and challenges for employers, including the following:

Potential opportunities

- Improved recruitment and retention: Remote work can attract and retain talent, particularly in competitive markets.
- Moderate pay growth: By tapping into a wider talent pool, employers can potentially control labour costs and moderate pay growth.
- Reduced space needs and overhead costs: Remote work can reduce the need for physical office space, leading to lower overhead costs.

Potential challenges

- Productivity concerns: Some employers worry that remote work can hinder productivity, especially for tasks requiring collaboration and innovation.
- Skills development: Remote work may limit opportunities for informal learning and skills development that often occur in traditional office settings.
- Workplace culture: Remote work can challenge the development and maintenance of a strong company culture, which often relies on face-to-face interactions.

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Ultimately, employers must carefully weigh the potential benefits and drawbacks of remote work to determine the best approach for their organisation. Some companies have successfully implemented hybrid models that combine remote and in-office work, while others have found that in-person collaboration is essential for their company's success.

Generally, unless the tasks for a given job are predominantly concentrated at the less-suitable end of the WFH spectrum, the intensity of WFH arrangements reflects choices [4] related to:

- Job design,
- Management practices,
- Organisational culture, and
- Employee lifestyles.

These choices are influenced by evolving perceptions of remote work productivity, the perceived stigma associated with remote work, the quality of remote collaboration tools, and an organisation's capacity to manage remote work arrangements effectively.

Productivity and work-from-home

A key question posed by Barrero *et.al.* [5] in their paper in terms of productivity is: 'How will a large, lasting shift to work from home affect productivity outcomes when working arrangements are a matter of choice rather than necessity, and when organizations and individuals have adapted to their preferred working arrangements?'

A number of studies have examined the impact of fully remote work and hybrid arrangements on the impact of productivity. In terms of fully remote work, several studies have found that fully remote work results in lower productivity. In terms of hybrid arrangements initial studies around the time of the pandemic found increased productivity levels, but more recent studies point to diminished productivity gains resulting in negligible improvements.

4. José María Barrero, Nicholas Bloom, and Steven J. Davis, "The Evolution of Work from Home", Journal of Economic Perspectives, 09 September.
5. José María Barrero, Nicholas Bloom, and Steven J. Davis, "The Evolution of Work from Home", Journal of Economic Perspectives, 09 September.

Fully remote working – significant productivity losses

The incidence of fully remote work is likely to return to pre-pandemic levels given the clear evidence of reduced productivity levels and the inherent requirements of most jobs.

For example, one study[6] found that the shift to fully remote work lowered average labour productivity (output per hour worked) by between 8% and 9%. The decrease in productivity was attributed to an overall increase in working time; a shift away from performing work tasks and towards spending time on meetings, calls, or answering emails; and reduced time networking with others or meeting face-to-face with one's manager.

Data in this study reveal a notable increase in overall working hours, extending beyond the traditional workday. Employees working remotely dedicate more time to meetings and calls, resulting in a corresponding reduction in 'focus time', a metric measuring uninterrupted work time. This persistent increase in meeting time, even after the initial transition to remote work, suggests substantial and ongoing coordination costs associated with WFH arrangements, potentially hindering productivity and efficient work practices. The persistent rise in virtual meetings highlights the potential challenges associated with remote work and the importance of optimising communication strategies to minimise disruptions and foster productive work environments. Consequently, the study indicates that roles which are characterised by more interaction and networking prior to WFH are more affected by the switch to WFH.

6. Gibbs, Michael, Friederike Mengel, and Christoph Siemroth, "Work from Home and Productivity: Evidence from Personnel and Analytics Data on Information Technology Professionals," Journal of Political Economy Microeconomics, 2023, 1 (1), 7–41.

Hybrid working arrangements – significant uncertainty about the impact on productivity

As highlighted above, initial studies of hybrid working arrangements published at the time of the pandemic found productivity gains (relative to traditional arrangements) or no discernible effect. A number of studies [7, 8] suggest that WFH one or two days per week improved productivity and leads to happier employees. However, the productivity gains associated with hybrid working arrangements in these studies reflected greater effort levels, (i.e. longer hours), albeit by happier employees.

Disparity in employer and employee perceptions of WFH productivity gains

Data from the US Survey of Working Arrangements and Attitudes conducted from January to June 2023 reveal a divergence in perceptions regarding WFH productivity. While 43% of workers capable of working remotely believe their productivity is enhanced in a home setting, only 14% report a decline in productivity. The remaining 43% perceive no significant difference in productivity between remote and in-office work.

It appears that workers primarily attribute the perceived productivity benefits of WFH arrangements to the elimination of commuting time. When this perceived productivity boost is factored out, the gap between manager and employee perceptions of WFH productivity narrows considerably.

This divergence in perspectives highlights a broader issue: the definition of productivity itself. Workers view commuting time savings as a direct contributor to productivity, whereas managers may not assign the same value to this factor. Conversely, workers may overlook the managerial challenges associated with remote work, such as maintaining team cohesion and fostering a strong workplace culture. Senior managers, in particular, may be more concerned about the long-term implications of remote work on these aspects of the organisational culture.

[7] Choudhury, Prithwiraj, Tarun Khanna, Christos A. Makridis and Kyle Schirmann, 2022. "Is Hybrid Work the Best of Both Worlds? Evidence from a Field Experiment," working paper.
[8] Bloom, Nicholas, Roubing Han and James Liang, 2023. "How Hybrid Working from Home Works Out," NBER Working Paper 30292.

Intangibles and WFH

The widespread adoption of WFH arrangements has brought about a noticeable decline in several intangible assets that contribute to both employee well-being and organisational success. These intangible assets include:

- Working Relationships and Professional Networks: The physical separation of colleagues has hindered the formation and maintenance of strong working relationships and professional networks. This can lead to communication silos, reduced collaboration, and a diminished sense of camaraderie among employees.

- Corporate Culture: The absence of in-person interactions has made it more challenging to foster and maintain a strong corporate culture. Spontaneous interactions, which often occur in a traditional office setting, play a vital role in shaping and reinforcing the company's values, identity, and sense of community.

- Unplanned Innovation: Remote work has significantly reduced the frequency of unplanned interactions, which are often the catalyst for new ideas, creative breakthroughs, and productive collaborations. The virtual nature of communication limits the opportunities for spontaneous exchanges that can spark innovation and problem-solving.

- Coaching and Mentoring: The decline in face-to-face interactions has impacted the availability of coaching and mentoring opportunities for employees. Regular feedback, guidance, and mentorship are crucial for professional development and career growth. Remote work may make it more difficult for supervisors to provide these valuable interactions.

- Human Capital Development: The overall reduction in these intangible assets is likely to slow the development of human capital within organisations. Employees may experience a decline in their ability to build relationships, navigate corporate culture, foster innovation, and receive mentorship, all of which contribute to their overall professional growth and development. While remote work may allow experienced employees to achieve greater short-term productivity, it could potentially hinder the transmission of tacit knowledge and expertise, which often occurs through informal interactions and mentorship opportunities in a traditional office setting.

The full impact of hybrid working on productivity and innovation and intangibles such as human capital development and culture will take time to correctly assess. However, the growing evidence is that WFH and hybrid working is probably having a detrimental impact on these work attributes.

In addition, it will be interesting to observe hybrid working patterns during an economic downturn. Currently, labour markets in most developed economies are quite tight with low levels of unemployment. However, in an economic downturn increased economic uncertainty could lead workers to prioritise job security over flexibility.

This could translate into increased office use and attendance. Consequently, it will probably require a full economic cycle to elapse before we can fully judge the durability of WFH rates and the ultimate impact on office use.

WFH intensity by industry

By their nature, certain industries are potentially more suitable for WFH arrangements than others. In the US [9], the ICT sector boasts the highest WFH rate, with employees who work at least five days per week averaging 2.6 days spent working remotely. The finance & insurance and professional & business services sectors follow closely behind with their own significant WFH rates.

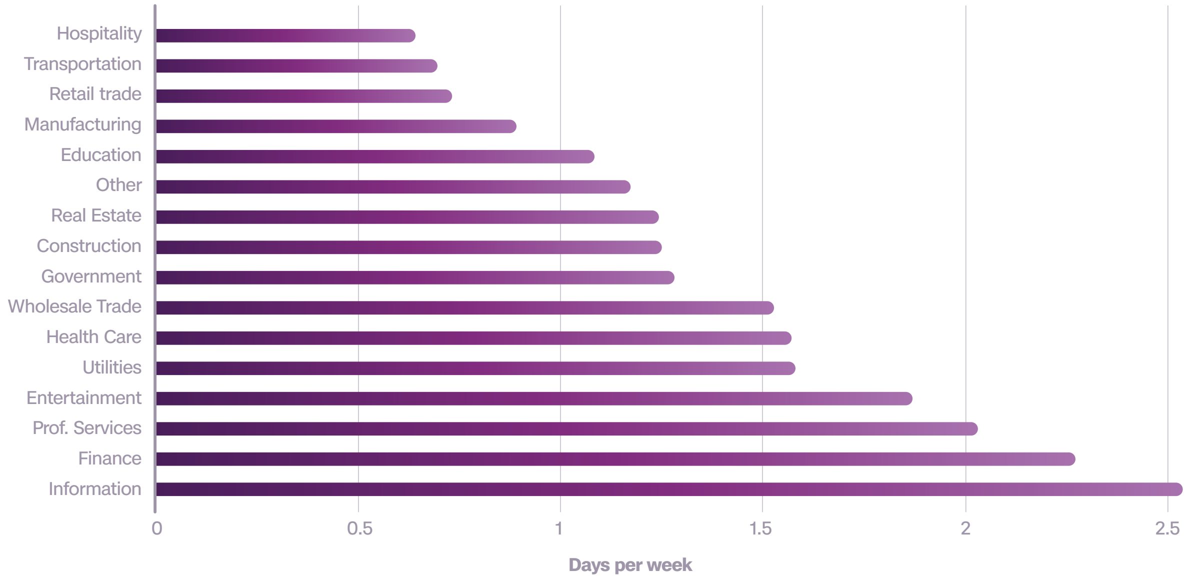
Several shared characteristics among these three sectors contribute to their high adoption of remote work arrangements:

- Analytical and computer-intensive job nature: Many jobs in the information, finance & insurance, and professional & business services sectors involve analytical tasks or extensive computer use. These types of tasks are often well suited for remote execution.
- Clustering of firms in major cities: Companies operating in these sectors tend to be concentrated in major urban centres, where long commuting times are a common reality. The ability to work from home can significantly alleviate commuting time, saving employees valuable time, money, and stress.
- Well-paid staff: Employees in these sectors generally receive higher compensation, making them more likely to have access to the resources and technology necessary to effectively work from home.

However, it is interesting to note that many employers in these sectors are now introducing return-to-work mandates or tightening the rules regarding hybrid-working.

[9] José María Barrero, Nicholas Bloom, and Steven J. Davis, 'The Evolution of Work from Home', 3 September 2023, Prepared for the Journal of Economic Perspectives

US WFH Rates by Industry Sector, 2023

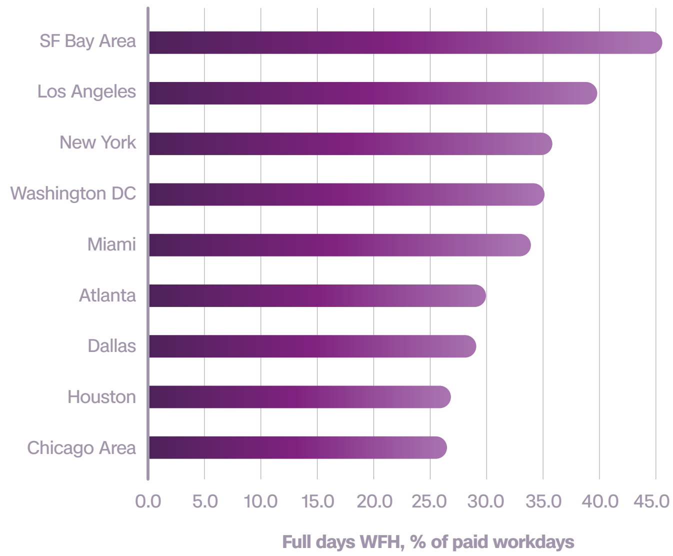


Source: José María Barrero, Nicholas Bloom, and Steven J. Davis, 'The Evolution of Work from Home'

WFH by population density

WFH intensity also varies by local population density as longer commuting times encourage high WFH rates in dense urban areas. In addition, in more densely populated areas, there is often a higher concentration of industries and occupations that are well suited to WFH, such as technology, finance, and professional services. Furthermore, in these areas, there is often a greater availability of high-speed internet and other infrastructure that supports WFH. Conversely, in more sparsely populated areas, there may be fewer jobs that can be done remotely, and the infrastructure for WFH may be less readily available. For example, according to Barrero et.al. [10] the San Francisco Bay Area, Los Angeles and New York have a higher incidents of WFH whereas Atlanta and Houston have lower incidence of WFH.

WFH and population density in US



Source: Barrero, Jose Maria, Nicholas Bloom, and Steven J. Davis, 2021. "Why working from home will stick," National Bureau of Economic Research Working Paper 28731.

[10] Barrero, Jose Maria, Nicholas Bloom, and Steven J. Davis, 2021. "Why working from home will stick," National Bureau of Economic Research Working Paper 28731.

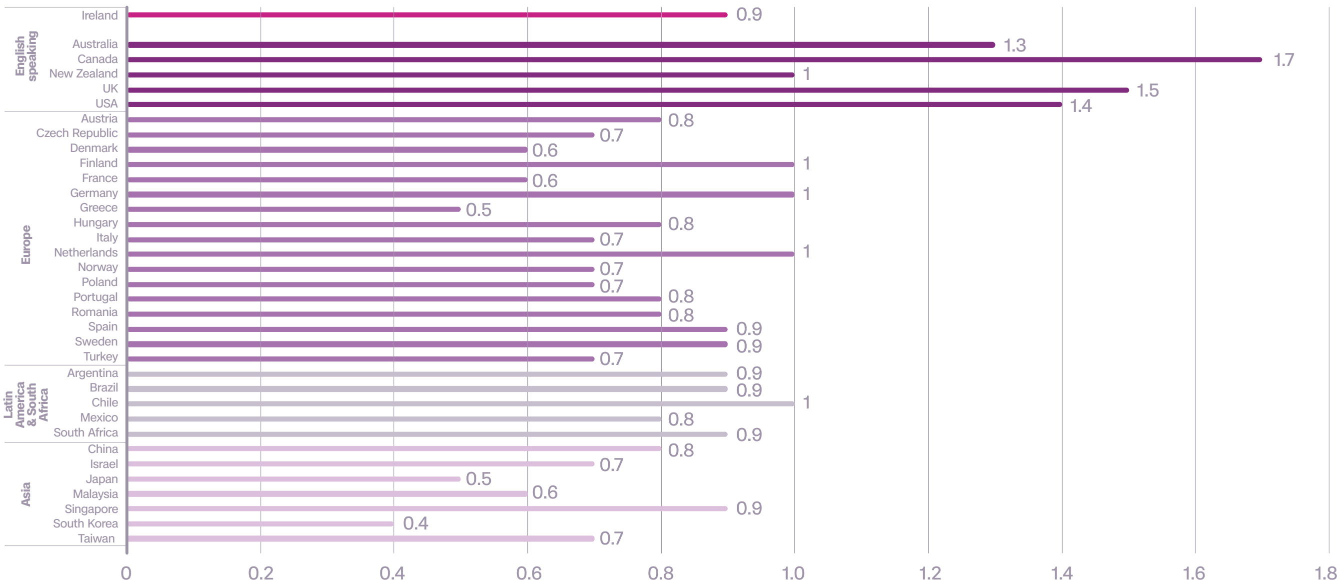
WFH patterns vary across the globe

A recent survey (Global Survey of Working Arrangements (G-SWA) [11]) conducted across 34 countries showed that full-time employees, on average, worked from home 0.9 days per week during the April-May 2023 period. These data, gathered from Wave 3 of the Global Survey of Working Arrangements (G-SWA), also highlight notable variations in WFH patterns in different regions.

English-speaking countries exhibited higher WFH levels than other regions. Across Australia, Canada, New Zealand, the UK, and the US full-time employees averaged 1.4 full-paid days worked from home each week. In contrast, WFH levels averaged only 0.7 full-paid days per week in the seven Asian countries included in the G-SWA, 0.8 full-paid days in European countries, and 0.9 full-paid days in four Latin American countries and South Africa.

WFH varies by region

Paid Full Days Worked from Home per week (April-May 2023)



Source: Global Survey of Working Arrangements

These averages, however, mask significant variations within each region. Among the English-speaking countries, average full-paid WFH days per week ranged from 1.0 in New Zealand to 1.7 in Canada. In Europe, Greece had the lowest WFH incidence (WFH days per week), while Finland, Germany, and the Netherlands had the highest values (1.0 WFH days per week). WFH days in Asia ranged from 0.4 in South Korea to 0.9 in Singapore, and in Latin America, WFH days per week ranged from 0.8 in Mexico to 1.0 in Chile.

The same survey [12] asked workers who worked four or more days per week, where did they work? It found that 67% of full-time employees worked five days per week on a business premises. Another 26% had hybrid arrangements, splitting their workweek between home and the employer's premises. Finally, 8% of full-time employees worked entirely from home.

Disconnect between employees' and employers' preferences

The survey findings revealed a disconnect between employees' and employers' preferences regarding WFH arrangements. On average, employees prefer to work from home 2.0 days per week, whereas employers only plan for 1.1 WFH days per week. This gap exists in all 34 countries surveyed, with the most significant disparity in Latin America and South Africa, where employees would like to work an additional 1.3 days from home in contrast to employers' plans. The smallest gap is observed in English-speaking countries, averaging 0.7 WFH days. Argentina, Brazil, and Mexico have the largest gaps, with 1.6, 1.2, and 1.2 WFH days, respectively. Conversely, Japan, the Netherlands, and Denmark have the smallest gaps, with 0.2, 0.3, and 0.4 WFH days, respectively.

[11] The G-SWA is an online survey of full-time employees aged 20-64 who have completed secondary or tertiary education. Sample sizes range from slightly more than 700 respondents in New Zealand to more than 2,500 respondents in France, Germany, Italy, the UK and the US. Conditional on the exclusion of persons who did not complete secondary school, the samples are broadly representative of full-time employees in each country with respect to age, gender and education.

[12] Among workers that worked 4 or more days during the survey reference week. Responses to the question "For each day last week, did you work 6 or more hours, and if so where?". Sample of N=39,021 workers in 34 countries surveyed in April-May 2023.

Ireland likely straddles the Anglo-Saxon and European rates of WFH

There are limited data on WFH trends in the Irish market, but many of the observations globally are applicable in a domestic context. Hybrid arrangements are a feature in the market and the Irish experience probably straddles that of the Anglo-Saxon economies and of our European peers. In other words, the WFH intensity in Ireland is not quite as substantial as that being experienced in the UK and the US but would probably be at the upper end of the European experience. Across the Anglo-Saxon economies, full-time employees averaged 1.4 full-paid WFH days each week and 0.8 days in European countries.

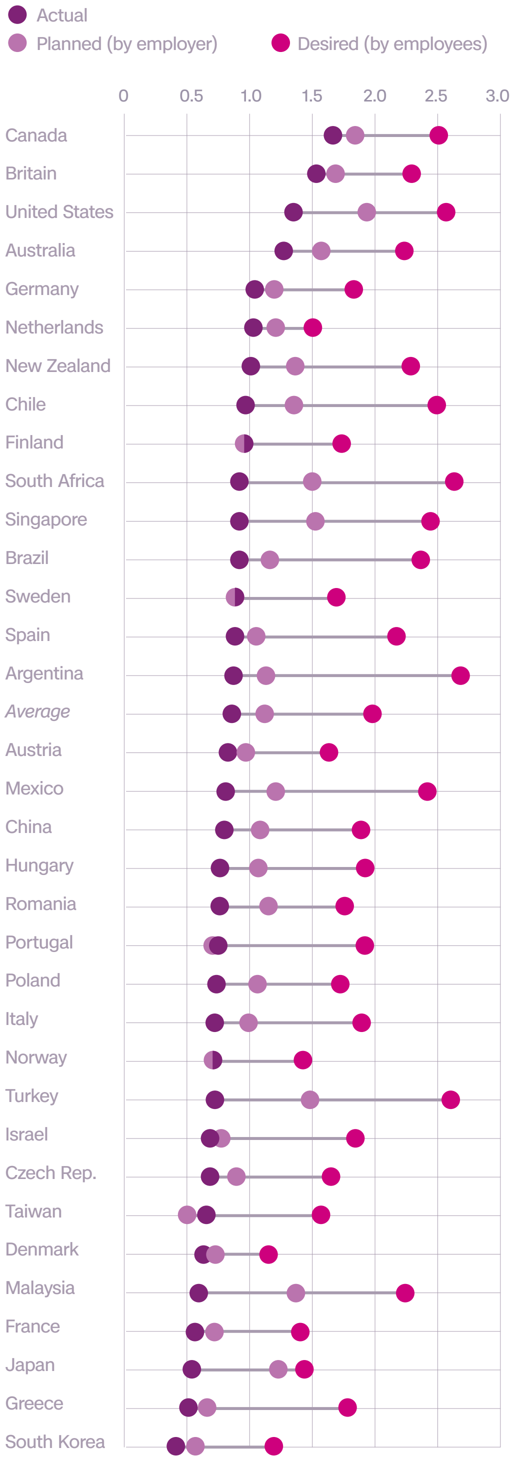
The Dublin Chamber Business Outlook Survey [13] in association with Savills provides some indications on the trends in WFH in the Dublin market. This is the second survey, and it points to increased use of the office but still significantly below pre-pandemic levels. Some of the main observations are:

- 55% of employees spend two or three days in the office on a weekly basis, an increase of 7 percentage points from Q4 2022.
- Increased use of 'core days' or 'core hours' - 33% of firms currently state that they offer total flexibility (not implementing any element of core days/hours), which is down from 45% in Q4 2022.
- 73% of firms state that the main reason they use hybrid and remote working is for recruitment and retention tactics.

Many of these trends are evident in international markets. It is interesting to note that the survey found that the main reason 73% of firms in the survey use hybrid working is that it is a recruitment and retention tactic. This suggests that in a labour market downturn the prevalence of WFH might change, and the pendulum may swing further back towards increased office use.

For example, in the US there have been active attempts to increase the use of the office in the finance sector and the ICT sector, two sectors where activity has started to cool. These efforts appear to be having an impact. According to Blomberg [14], [F]ewer than 26% of US households still have someone working remotely at least one day a week, a sharp decline from the early-2021 peak of 37%, according to the two latest Census Bureau Household Pulse Surveys. Only seven states plus Washington DC have a remote work rate above 33%, the data shows, down from 31 states and DC mid-pandemic.'

Remote prospects
Full-time days working from home
Latest week average, April-June 2023*



Source: WFH Research

*Surveys of over 35,000 workers in 34 countries

Source: The Economist

[13] Over 320 companies throughout the Dublin region participated in this survey. While the sample size is relatively small, it does facilitate the tracking of trends over time.
[14] Bloomberg,' American Work-From-Home Rates Drop to Lowest Since the Pandemic', October 2023

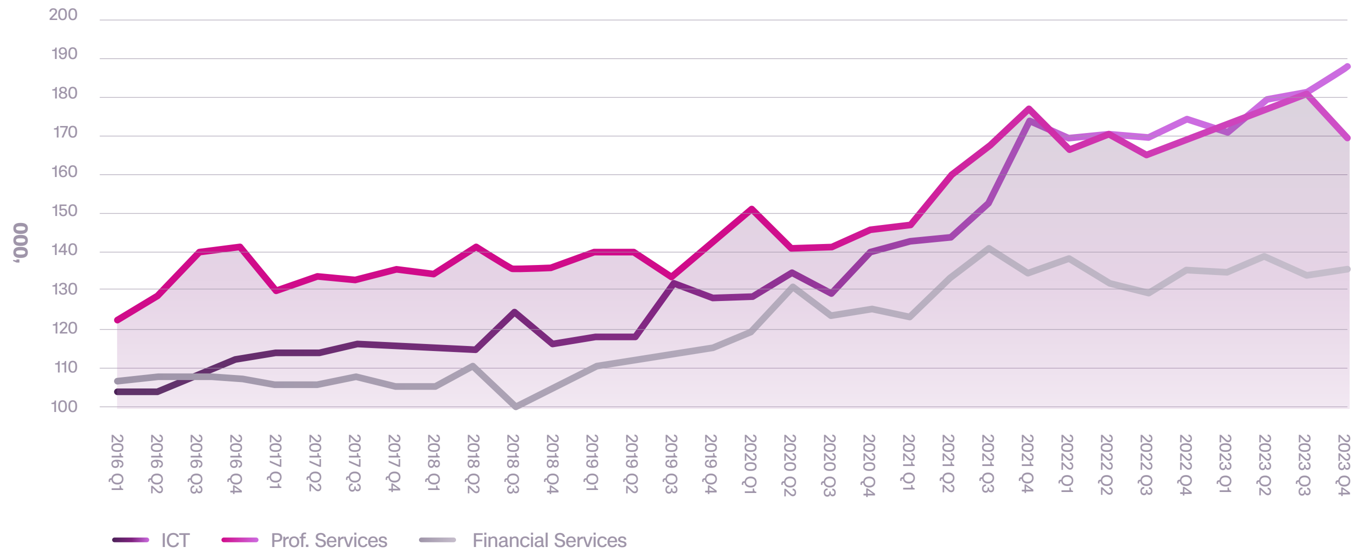
Ireland has a large concentration of workers in sectors with potential for high WFH densities

As previously highlighted, the top three sectors with the highest incidence of WFH rates in the US are ICT, finance and professional services, sectors that the Dublin office market is particularly exposed to. However, these sectors, in particular the ICT sector are growth oriented, which should help mitigate much of the WFH impact on the Dublin office market over time, given existing clustering effects and FDI ability.

WFH prospects

Ultimately, the true impact of WFH arrangements on overall productivity remains a complex and evolving issue, influenced by a multitude of factors, including individual work styles, task requirements, organisational culture, and managerial practices. It does appear that fully remote working leads to lower productivity and significantly so in some cases. However, the assessment of hybrid working is more complex. Some studies show modest productivity gains, while others show negligible gains. But, in general, they find employees to be happier. On balance, this would indicate that the hybrid working pendulum will likely swing more towards the office over time and away from the home.

Irish employment growth in key WFH sectors



Sustainability and the office market

Pressure to transition coming on all fronts

A combination of legislative and regulatory requirements and increased demand by both investors and tenants are the key drivers in the transition of the office market to more energy-efficient ratings and ultimately to the target of zero-emissions buildings (ZEB).

Summary of the key legislation for climate action in real estate in Ireland and Europe

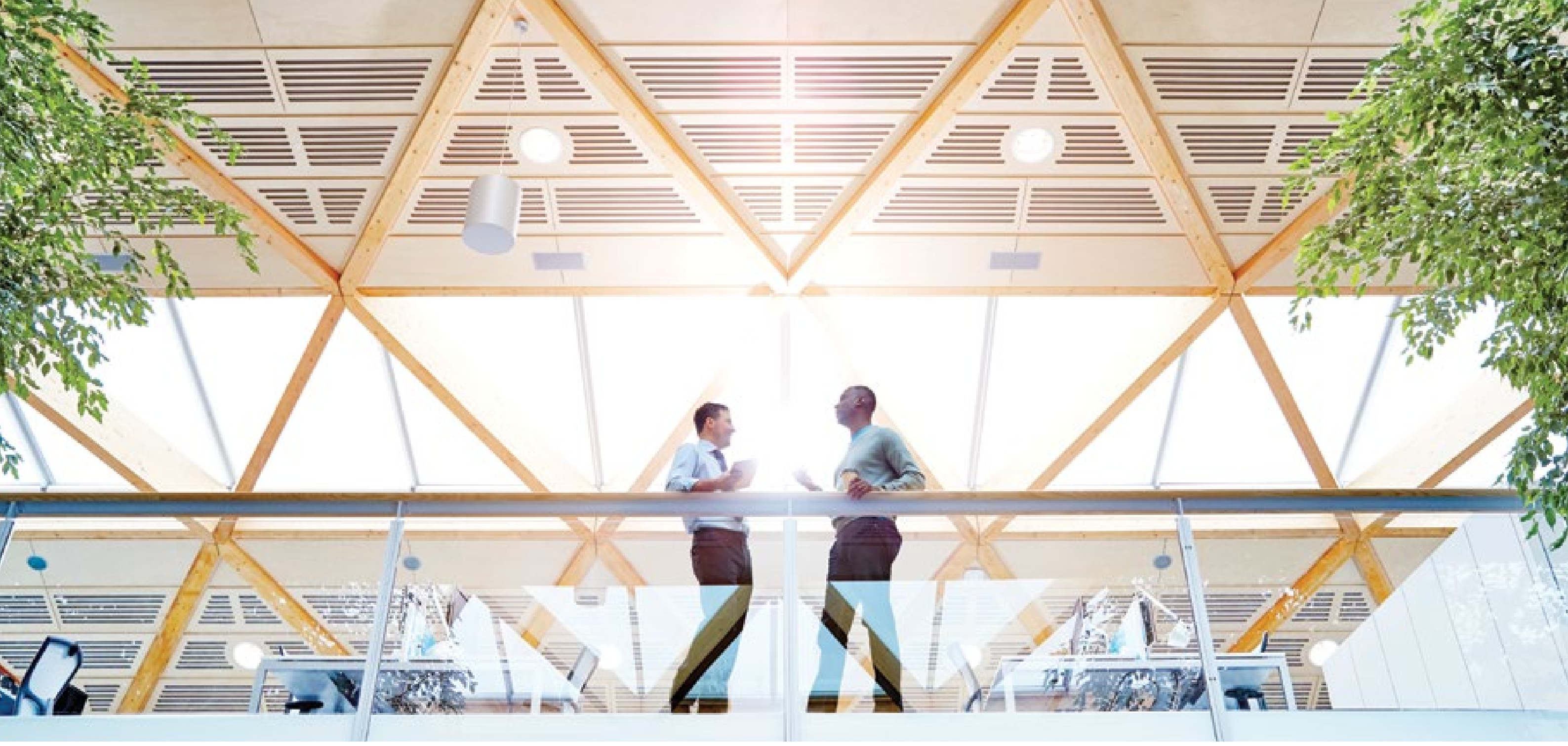
European Legislation:

- Energy Performance of Buildings Directive ('EPBD'): This directive requires to renovate the 16% worst-performing buildings by 2030, and the 26% worst-performing buildings by 2033, to certain energy performance standards.
- Sustainable Finance Disclosure Regulation ('SFDR'): This regulation requires financial market participants to disclose information about the environmental sustainability of their investments, including those related to real estate. The impact of this legislation will primarily impact purchasers.
- Corporate Sustainability Reporting Directive ('CSRD'): This directive, aimed at improving the consistency and quality of ESG reporting by companies, requires most larger companies in the EU to report on their performance. The impact of this legislation will primarily impact tenants.

Irish Legislation:

- Climate Action and Low Carbon Development (Amendment) Act 2021 provides a framework for developing and implementing national climate policy in Ireland, including establishing a national mitigation plan.
- Building Regulations: The Building Control Acts 1990-2014 require all building works in Ireland to comply with specific building regulations, including those related to energy efficiency and greenhouse gas emissions.

03



From a regulatory perspective, the Recast Energy Performance of Buildings Directive (EPB Recast Directive) [15] is a significant step towards the European Union's decarbonisation goals. This directive requires to renovate the 16% worst-performing buildings by 2030, and the 26% worst-performing buildings by 2033, to certain energy performance standards. According to Lisney, 'this will result in one in four commercial buildings being required to be upgraded in less than 10 years. By applying this percentage to the Non-Domestic BER rating statistic for 2023, all G, F, E, and some D-rated buildings will require renovation.'

- Capital raising and ESG credentials: Institutional capital raising and ESG requirements are becoming increasingly intertwined as investors and asset managers prioritise ESG factors in their investment decisions. ESG considerations are influencing the types of investments that institutions are willing to support, the terms of those investments, and the reporting requirements associated with them. Pressure from the ultimate beneficiaries is a key reason why funds are incorporating ESG factors into their investment strategies. It should be noted that SFDR defines three key types of investment funds:
    - Article 6 - investment products that do not integrate any kind of sustainability into the investment process.
    - Article 8 – 'light green' investment products that promote, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices.
    - Article 9 – 'dark green' investment products that have sustainable investment as an objective and an index that has been designated as a reference benchmark.

[15] In 2002, the EU embarked on its first endeavour to enhance the energy efficiency of its buildings with the EU Energy Performance of Buildings Directive (2002/19/EC). Since then, the directive has undergone numerous revisions, culminating in the 2018 Energy Performance of Buildings Directive (2018/844), commonly known as the "2018 Directive," which set the ambitious objective of achieving near-zero energy buildings whenever feasible and practicable. On March 14, 2023, the European Parliament took another significant step toward achieving its decarbonisation goals by adopting the European Commission's proposed amendments to the 2018 Directive, commonly known as the "EPB Recast Directive."

Article 9 funds (i.e. ESG funds) now account for more than 50% of the European fund market. Consequently, CRE asset managers, like all other asset managers, will be very mindful of these fund flow trends.

- Higher rental rates: Energy-efficient buildings are often in higher demand among tenants, who are increasingly seeking spaces that align with their commitment to sustainability. Highly energy-rated offices have the potential to command lower void rates, higher rents, and improved operating profit, with capital values and liquidity being enhanced as a result. In addition, due to the demands of CSRD, many tenants are also approaching their landlords to establish if a collaborative approach could be adopted to ensure the property is retrofitted to the mutual benefit of both landlord and tenant. This collaboration is also evident in the trend for the inclusion of 'ESG clauses' in leases. These typically seek the right of the landlord to receive energy data for the property and a clause to ensure that any tenant fit-outs do not have a negative impact on the BER rating.
- Differentiated risk premiums: The risk premiums associated with office assets are likely to change significantly over time, depending on the sustainability rating of the property and its likely exposure to the risk of climate change. The yield/capitalisation rates of property incorporate this risk premium and are for the most part determined by perceptions of risk, such as risk of vacancies and expected property cash flows, including rental growth. However, determining the appropriate risk premium to compensate for climate risk and sustainability will not be straightforward. Differentiated risk premiums between prime, secondary and the rest is already evident in the Irish office market and the likelihood is that this differentiation will become both engrained and more pronounced over time.

Evidence of a green premium or brown discount?

A growing consensus suggests that office buildings with high-quality green certifications command a green premium; however, the size of this premium is still uncertain. In their 2020 study, Leskinen et al. [16] carried out a large-scale literature review of the impact of green building certification on the cash flows and values of commercial properties. In general, research has consistently found rental, sales price, and occupancy premiums in certified buildings, spread across different markets, property types and certificate types. While each of these factors has quite a wide range, they all generally point in the direction of an inherent premium for green certified buildings.

The table below summarises the study findings in terms of the impact of green certification on rental income, occupancy, operating costs, yields and sales price.

In their study, Leskinen et al. found that sustainably certified buildings command rental premiums ranging from zero to 23%. These higher premiums serve as a significant market incentive for property developers and owners to prioritise the environmental performance of their holdings. The prospect of higher rental income is a powerful motivator for investors to pursue green building projects, even if they involve upfront cost premiums. Tenants are willing to pay premium rents for certified buildings due to potential productivity gains, corporate benefits, and lower operating costs, especially if they manage these expenses.

The Leskinen et al. study also found that certified buildings exhibit occupancy rates that exceed those of non-certified counterparts, ranging from 1% to 17% higher. However, the positive impact of green certifications on occupancy rates may vary across different submarkets and asset classes, mirroring the dynamics of rental premiums.

Certified properties compared with non-certified properties (that are broadly similar otherwise) exhibit lower yields, possibly reflecting the fact that less risk is attached to those properties. According to Leskinen et al., '[W]hile rental income and sales prices reflect a property's current income and capital value, initial yield also takes into account these important expectations of its future market position, where sustainability might play an important role. Lower initial yield usually means lower investment risk, increased number of potential buyers, lower expected depreciation, and higher rental growth.'

The combined impact of higher rents, lower vacancies, potentially lower operating costs and lower yields lead to higher sales values. The study found quite a wide range in sales price premiums, ranging from 0% to 43% with a mean of 14.8%. The wide range in reported values is not surprising as values will vary across property type and segment and also because there are different interpretations and measures for what constitutes a green, sustainable building.

The following two charts summarise results from key studies estimating the rent and price premium in US and UK office markets since around 2014, and point to wide range in the size of the 'green' premium.

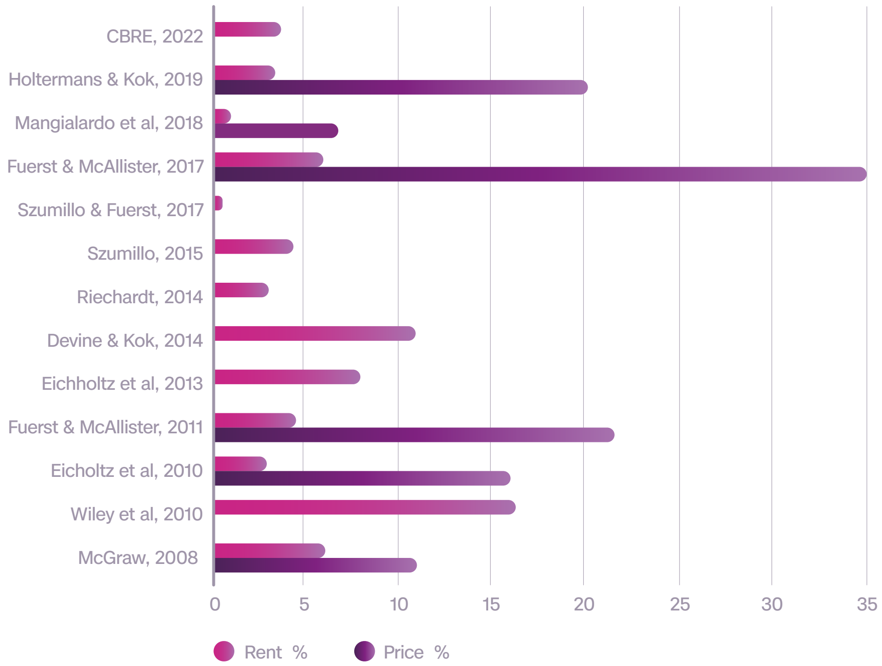
The effect of green certification on property fundamentals

Property parameter	Effect	Range	Mean	Median
Rental income	Increased	0.0-23.0%	6.3%	4.6%
Occupancy	Increased	0.9-17.0%	6.0%	4.3%
Operating costs	Inconclusive	-14.3-25.8%	-0.4%	-4.9%
Yield	Decreased	0.36-0.55%	0.46%	0.46%
Sales price	Increased	0-43.0%	14.8%	14.1%

Leskinen et al., 2020

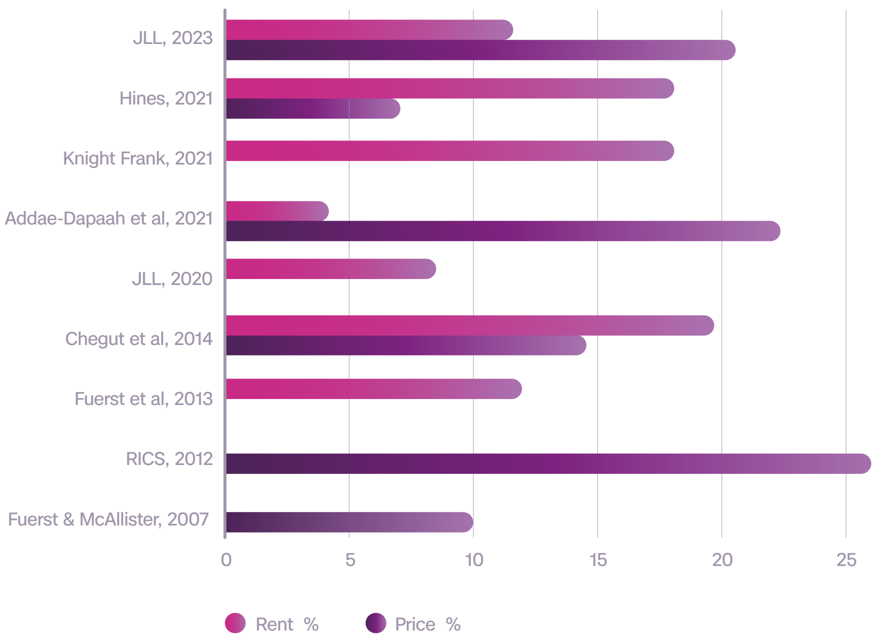
[16] A Review of the Impact of Green Building Certification on the Cash Flows and Values of Commercial Properties by Niina Leskinen, Jussi Vimpari and Seppo Junnila, March 2020.

Estimated 'Green' Premium – US Offices



Source: PMA

Estimated 'Green' Premium – UK Offices



Source: PMA

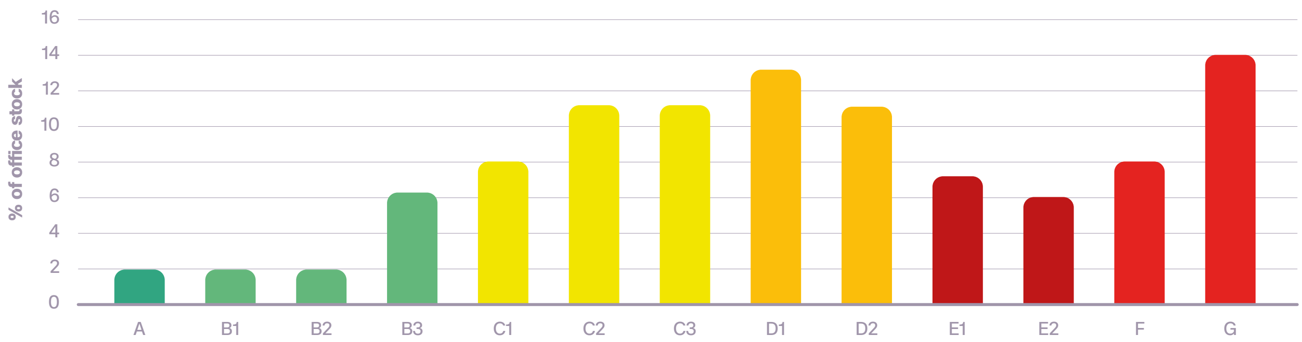
While the exact size of the green premium is difficult to quantify, it is increasingly evident that the size of the premium is significant. The green premium does need to be substantial in order to encourage the development of highly energy-rated new stock and to justify the cost of retrofits and redevelopments. Without a substantial green premium, the market incentive would be absent.

Limited amount of energy-efficient office space

Like many other countries, Ireland has a limited supply of energy-efficient office space. The majority of office buildings (89%) have a BER of C or lower, while only 2% have a BER of A.

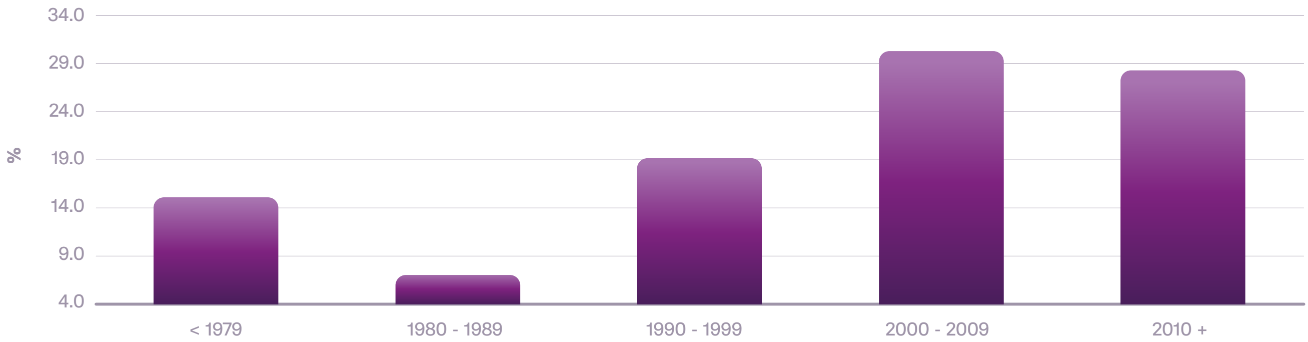
The age profile of the Irish office market is consistent with the BER profile of the market. Based on MSCI data, we estimate that 28% of office stock has been built since 2010 and a further 30% was built between 2000 and 2009, with the balance, 42% built prior to 2000.

Irish office BERs 2009 - 2023



Source: CSO

Age profile of the Irish office stock

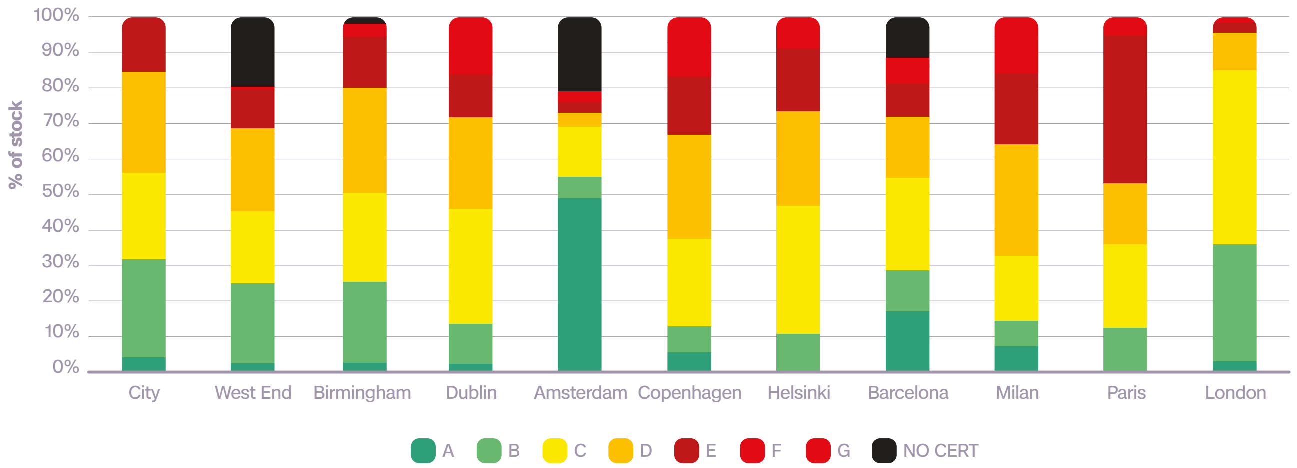


Source: MSCI/IPD

Dublin at the lower end of the scale compared with European peers

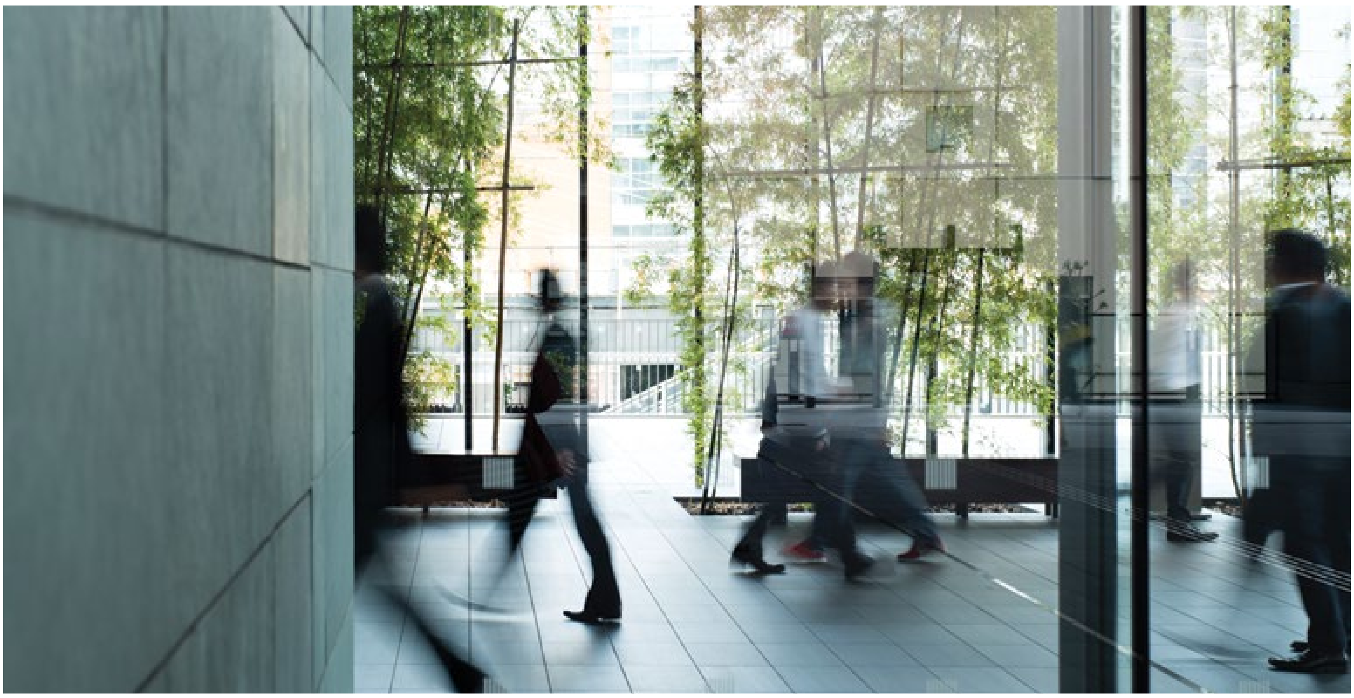
The stock of A and B BER (EPC) rated buildings in Dublin is at the lower end of the scale compared with other European office markets. There is a wide range of EPC ratings across European markets, but it should be noted that standards are not uniform and, as they are valid for 10 years, many EPCs do not reflect the current state of a building.

EPCs as a % of stock (including non-certified)



* NB in France and the Nordics, EPCs are only recorded on buildings that have been sold and let since measures have been introduced
**Lisbon A+ category (0.2%) shown with EPC A, and EPC B-category (21.9%) shown with EPC B; Lisbon data is for all commercial properties
***Milan EPC A4 (0.3%), A3 (1.0%), A2 (2.3%), A1 (3.8%) categories shown all together as EPC A grade
**** Paris & Dublin data is only for those buildings certified

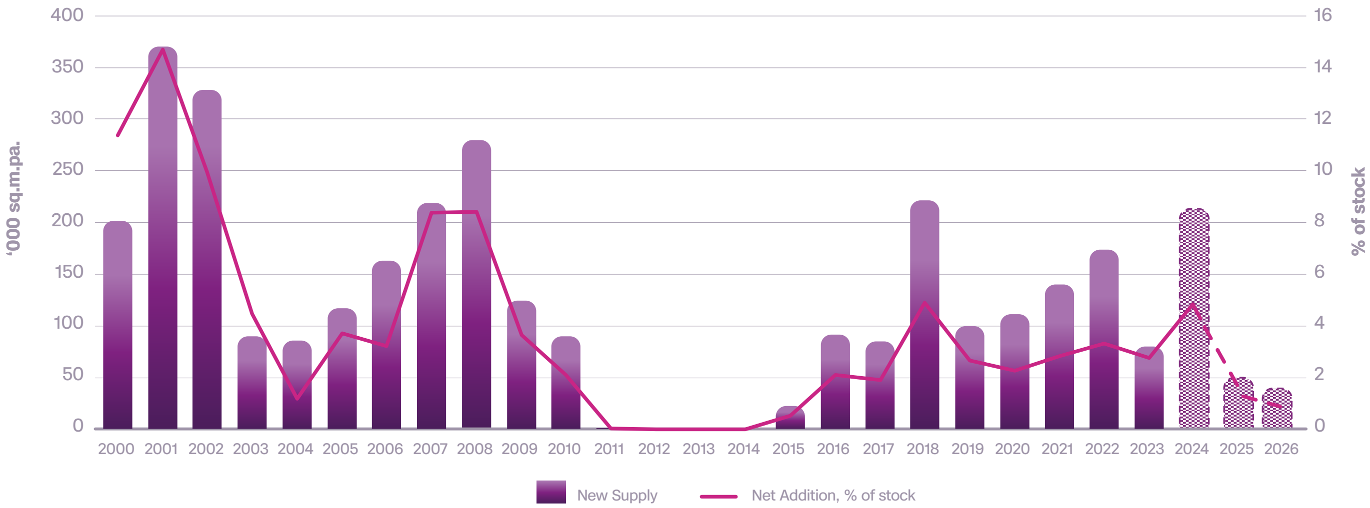
Source: PMA



Limited new build office supply after 2024 in the Dublin market

Speculative office development has been held in check in the Irish market and this has helped to ensure that new supply has never run too far ahead of underlying demand. Approximately 70,000 sq.m. of new supply is estimated to have been delivered in 2023 and new supply is expected to fall significantly from 2025 onwards. In fact, the future supply estimates are likely to be overstated as some developments may be mothballed. This disciplined approach to new office supply is a very positive feature from a market stability perspective, as it will help to mitigate the decline in office values.

Dublin office completions and net additions



Source: PMA, AIB and various agents' research

However, it does pose a problem for the supply and availability of highly rated, energy-efficient buildings. With little new supply coming on stream, and a limited number of refurbishments occurring, this could cause a supply/demand imbalance in the coming years if occupancy demand recovers – and particularly as institutional occupier demand is increasingly focused on the best, most highly rated office properties. While occupier demand was very subdued in 2023, it is likely to recover over the coming years and result in a tightening office market, especially for prime, Grade A stock and is likely lead to an even greater demarcation between prime, good secondary and the rest in terms of rents and yields. However, this demarcation is necessary in order to spur either new development or, more importantly, the redevelopment/refurbishment of existing stock. However, the key game changer in driving up the energy rates of the office stock in Ireland will be refurbishment /retrofitting rather than new builds.

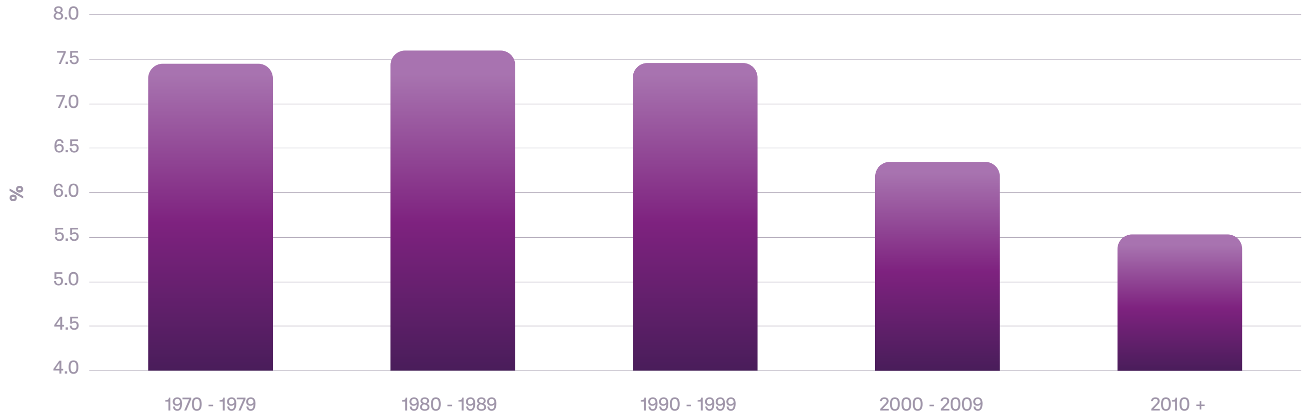
Redevelopment/refurbishment potential in the Irish office market

In this regard, it does appear that the scope for redevelopment/refurbishment appears to be increasingly viable in the Irish market based on yield spreads between different office categories in the market and evolving rental dynamics.

The following chart (based on MSCI data) illustrates the yield differentials between office properties in the Irish market by age. While a myriad of factors influence the yield and rent of a particular office property - including age, location, market cycle, grade, occupancy, lease terms etc - the following chart points to a significant spread between yields of office properties of different vintages.

Scope for refurbishment – wide yield spread an important requirement to ensure viability

Irish office yields by age



Source: MSCI

Based on MSCI data there is a yield (equivalent yield) spread in the region of 100 basis points between offices built in 2010 or later and those built in the period 2000-2009 and a yield spread of approximately 200 basis points for those built prior to 2000. This yield spread is probably even wider for those properties built after 2020 and is likely to be in the region of 250 to 300 basis points compared with pre-2000-built offices.

Rental dynamics in the Irish office market also appear to be reflecting this demarcation between office properties of different vintages. The table on page 39 summarises the change in office rents between March 2021 and September 2023 and highlights the rental outperformance of newer office stock.

Office rents from earlier vintages saw declines ranging from 0.4% to 4.5% over the period under review whereas office rents of 2010 vintage and later increased by 2.7%. This disparity in performance is likely to be a feature of the market over the coming years given the limited new supply of Grade A stock.

These trends in yield and rent demarcation are necessary incentives to encourage redevelopments and refurbishment and will play an important part in making the green transition for office property viable.

AIB is committed to creating a more sustainable community. In the context of office properties, this entails working with our customers to improve the energy efficiency of their buildings, thereby having a positive impact on the environment and reducing the risk to our customers. Therefore, we ask our customers to have a retrofitting plan incorporated into their lending proposals. If that plan is not available, we will provide a period of time to give the borrower an opportunity to get the appropriate external advice to develop such a plan.

Office rental performance by vintage

Office Vintage	% change in rents (Mar'21 – Dec'23)
Office Market	-1.0%
Office: 1970 - 1979	-5.5%
Office: 1980 - 1989	-5.1%
Office: 1990 - 1999	-2.3%
Office: 2000 - 2009	-0.6%
Office: 2010 +	3.6%

Source: MSCI

The cost of the office transition and its funding

Notwithstanding the improving market incentives, one of the primary challenges is the funding of this transition, due to its potential size and also the degree of uncertainty around the cost of this transition.

Although more data is gradually becoming available, the cost of conversion from a conventional building to a sufficiently high energy rate (BER A or B) is still highly uncertain. Such costs are likely to represent a high percentage of capital values in lower-rated-buildings (where values are low, but the need is probably the greatest).

The cost of refurbishing space to enable it to move to a BER A or B pathway varies hugely on a property-by-property basis, depending on the building structure and its mechanical and electrical systems. On the basis of using today's technology, retrofitting to hit BER A or B targets will not be possible in all cases. Indeed, an investor survey conducted by Property Market Analytics (PMA, a property research firm) suggests that where carbon audits have been undertaken, this will not be achievable for roughly one in five buildings. PMA has also estimated that the cost differential between a standard major refurbishment and a refurbishment to meet a zero-emission requirement would range between 25% and 35%. Consequently, it is evident that the spread in value between old and new properties requires significant yield and rent enhancements.

Summary

While the office sector was probably one of the first CRE sectors to be impacted by ESG requirements, it still has a long road to travel to meet the climate targets set by governments and regulators.

The majority of office buildings (89%) have a BER of C or lower, while only 2% have a BER of A.

The push towards higher-rated-buildings has already created a bifurcation in the market, with widening valuation gaps between prime, secondary and tertiary office properties. However, this valuation bifurcation is necessary to ensure that refurbishment and retrofitting of lower rated office properties are viable options.

Conclusion

The Irish office market has experienced a significant decline since 2022. However, the current downturn looks reasonably mature based on various metrics, and we estimate the market is modestly undervalued based on underlying fundamentals. However, market, generally undershoot their fair value before a recovery ensues and thus some further downside is likely in the market in the short-term.

Structural changes have impacted the office market with ESG and WFH considerations paramount. These structural changes have caused a demarcation in performance between prime, good secondary and the rest of the office market. We believe these demarcation pressures will continue in the Irish office market for the foreseeable future - that is, one market where a recovery in occupier demand will face limited new supply, which should result in lower vacancy and ultimately rental growth. In contrast, other parts of the office market may struggle to attract occupier or investor interest.

The ESG requirements facing the office market are significant and are inexorable in nature. While the office sector was probably one of the first CRE sectors to be impacted by ESG requirements, the sector still has a long road to travel to meet the climate targets set by governments and regulators and to meet the expectations of tenants and investors.

WFH is the other key structural factor that has impacted the office market since the start of the Covid-19 pandemic. However, it appears that the pendulum is gradually starting to swing back in favour of the office over the home. Many companies are introducing various forms of return-to-work mandates. Also, while the initial assessments of the introduction of WFH on productivity were generally positive, more recent assessments point to negligible benefits.

In addition, the introduction of WFH arrangements has brought about a noticeable decline in several intangible assets that contribute to both employee well-being and organisational success. While flexibility in working patterns will likely be an enduring feature of the workplace, the norm will probably be greater office use going forward.

In the period from late 2021 to late 2023 the market was impacted by rising interest rates which contributed significantly to the decline in office values over that time period. It does appear, however, that the interest and inflation cycles have turned, with markets expecting a significant easing in monetary policy over the coming 12 months. This has already manifested itself in a sharp fall in bond yields and swap rates which should ultimately be supportive of office market valuations.

However, the immediate outlook for the office market remains quite challenging, with further downside likely. Nevertheless, we believe the cycle is mature and the vast bulk of the correction is behind us. What is required to confirm this view is increased transactional evidence and increased liquidity in the Irish market.

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