CUSHMAN & WAKEFIELD | INTER ISRAEL

INTER NEWS

August 2020

Macro Survey

The Office Market in the Shadow of COVID-19

Working from Home or from Any Place?

Office Market Survey, H1 2020

Dear readers,

The economic uncertainty and instability due to the global COVID-19 crisis are obviously also having an effect on the commercial real estate market.

On the one hand, there is a sense that the pressure to finalize a transaction has been completely removed. Companies and businesses are recalibrating their path in view of the situation and building a strategy to acclimatize to the situation in various areas: the nature and volume of fundraising, the format of work, the organizational structure, lowering current expenses and so forth. On the other hand, the crisis has created new opportunities, mainly for tenants, including attractive subleases and increased interest in serviced office space solutions.

We are seeing real estate developers commit to leniencies and retention of existing tenants and a high level of flexibility in finding creative solutions for new tenants, including longer grace periods, lower financing coefficients for fit-out works and general flexibility in rental agreements.

Since the office market is currently volatile and unclear, the current study focuses on trends that we have seen in Israel and those that have been observed abroad, as opposed to the in-depth analysis that we presented in the past. We wish all our readers much health, a rapid exit from the crisis in all aspects and much success with the opening of new opportunities that have been created.

Enjoy reading,

Yoram Blumenthal
Co-Managing Partner

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Inter Israel, the Israeli partner of Cushman & Wakefield, is the leading business and commercial real estate consultancy firm in Israel, specializing in consulting, project marketing and asset management in Israel and abroad, investment in income-producing real estate, including purchasing and sales.

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Twice a year, our research department surveys trends in the office market in Israel and in various markets around the world.

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Marco survey: Israeli Hi-tech recorded growth, also in the first half of 2020

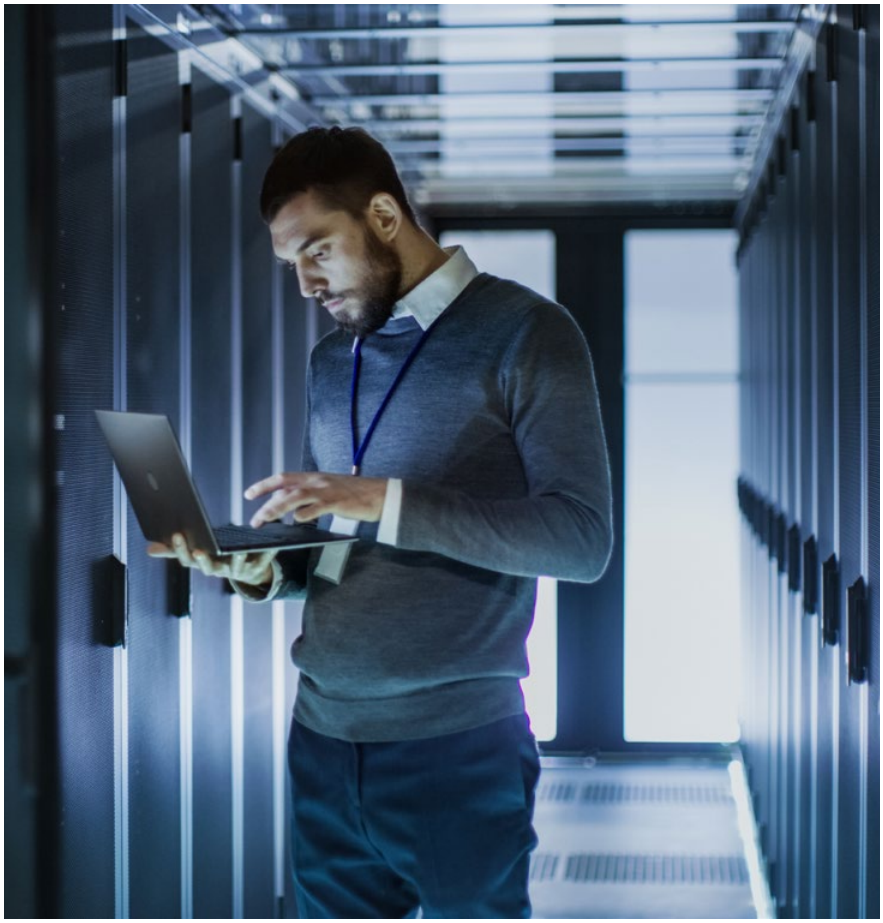
The International Monetary Fund recently published its expectation of a more serious global recession than its initial forecast at the beginning of the COVID-19 crisis. According to their assessment, the crisis will lead to a 4.9 percent decline in global GDP, compared with an assessment of just a 3 percent decline in the April forecast. The IMF also believes that the recovery will be weaker than they initially thought, with 5.4 percent global growth in 2021.

According to the IMF's forecast, GDP in the EU will drop by more than 10 percent. Likewise, the US economy will contract by 8 percent. In the US, the Fed's interest rate was left unchanged and most economists believe that it will remain at near-zero levels at least until 2021. It was also published that GDP in the US plunged by 32.9 percent in the second quarter. In annual terms, this was the sharpest drop since the US started publishing GDP data in 1947. The data from Germany are also not encouraging. GDP dropped by 10.1 percent in the second quarter, the sharpest drop ever since 1970.

In Israel, Bank Leumi recently revised its economic growth forecast for 2020 downward. According to Bank Leumi's forecast, GDP growth in 2020 was revised from -4.6 percent to -7.9 percent and there could be a double-digit decline in the business sector.

In terms of 2021, in a scenario that assumes a return to activity at a later stage this year, Bank Leumi expects growth of 5.5 percent, but if the restrictions on activity continue into the coming year, they expect growth of just 3.2 percent.

Ministry of Finance Chief Economic Shira Greenberg published a forecast that the Israeli economy will contract by 5.7 percent this year, while the deficit will exceed 13 percent in the likely scenario and exceed 14 percent if the recovery is slower, which will lead to a debt to GDP ratio of more than 80 percent in the coming years.



Hi- Tech: The main accelerator of the Israeli economy

In an optimistic view, looking at the hi-tech field, which is one of the main influencers in the commercial real estate field in Israel, there was growth in the first half of the year despite the COVID-19 outbreak and its global macroeconomic effect.

A recently published study conducted jointly by the Meitar Law Firm and IVC institute, showed that in the first half of the year, compared with the second half of 2019, the number of exits declined (from 77 to 55), but there were increases in the average exit level (from $98 million to $112 million), the total amount of investments made (from $3.7 billion to about $5.2 billion) and the number of investments made.

A major part of the growth engine of hi-tech in Israel is its human capital and the uniqueness of Israeli brainstorming. Numerous studies show that design, functionality and convenience of the space in which we work have a direct impact on the creativity coefficient and teamwork at hi-tech companies. This component of companies' office relocation budgets has increased and has had a major effect on recruitment strategies in recent years. As a result, there is a question of how much companies will be able to forego regarding this important element in their prosperity in view of the trend of individuals working from home or remotely.

The biomed and technology fields are expected to hit record high annual recruitment.

Still, there are those who argue that the balance of forces between investors and entrepreneurs has changed and that investment round valuations seem less generous.

With forecasts around the world indicating negative growth in 2020, the assessment is that the Israeli economy will not recover easily before the global economy recovers.

And what about the rest of the world?

The markets are reopening

A study conducted recently (July 2020) by Cushman & Wakefield surveying the level of markets reopening, shows that Europe leads with an average of more than 80% open in European countries. The study included 86 countries on all continents and relates to 10 macroeconomic components:

- **Essential services**
- **Retail activity**
- **Opening of borders**
- **Personal services**
- **Manufacturing**
- **Leisure / food and beverage**
- **Return to routine in schools**
- **Volume of office-based work**
- **Opening of construction sites**
- **Public gatherings**

Opening Rate	City/Country
*Highest rates of opening	
Atlanta	75%
Czech Republic	95%
Slovakia	95%
Vietnam	100%
Lowest rates of opening	
Sacramento	35%
Los Angeles	45%
Greece	65%
Brazil – Rio de Janeiro	55%
Indonesia	25%

* Over 70% of all countries in the world.

SOURCE: Cushman & Wakefield's Global Reopening Tracker Report 2020

Business & Pleasure

In its most recent survey, Cushman & Wakefield also noted the effect of the COVID-19 outbreak on the hotel industry, with declines in overall income in the first half of 2020 of 59 percent in Europe, 55 percent in Asia-Pacific, 46 percent in the US and 41 percent in the Middle East and Africa.

However, this industry is recovering rapidly, perhaps the most rapidly of all industries, as hotels are finding a variety of short-term income solutions, such as offering delivery services, reuse and utilization of hotel rooms as office space or as private dining rooms.

One of the more creative solutions includes "recreation bonds", which give investors the option of purchasing a voucher for future hospitality on the basis of "pay now (at a discount), stay later". For instance, the London House hotel in Chicago provides a "bond" for $100, which increases in value by 50 percent after 60 days. Redemption of the bond covers all services offered at the hotel, at the investor's choice, from lodging to purchasing beverages at the hotel's bar. Contrary to office buildings, where smart technology is implemented in only small numbers, hotels have implemented such technology for a number of years already, whether to increase efficiency or in order to attract exclusive customers or for branding purposes. Examples include less-touch elevators, room service applications, smart cleaning systems, automatic HVAC services and more. This may turn out to be a significant element in contributing to a more rapid recovery. In places where hotels have become critically distressed in the second half of 2020, there are thoughts of converting them to healthcare facilities, joint student residences and more.

Six feet office

As part of the need to implement the "new reality" and to understand how to get a large global work force back into the work place, while providing a sense of safety, Cushman & Wakefield published a policy paper at the start of the outbreak called "Six Feet Office". This policy is based on the firm's work with about 10,000 organizations in China, alongside consultations with people from the medical and governmental sectors in leading European countries. It includes 6 recommended rules for companies to implement in order to return to a safe routine. A number of global organizations have already implemented it and have even complimented this policy.

Among other things, the plan includes the use of visual hints to create separate "walking directions" for those coming in and going out, ensuring 2 meters of separation between employees. It also creates simple rules for day-to-day behavior, equipping workstations with relevant safety items and more.

The office market in the shadow of COVID-19

In the first two-and-a-half months of the year, until the outbreak of the pandemic, asking rental prices were stable, as were occupancy rates. In Tel Aviv's Central Business Districts (CBDs) for example, asking rents remained at an average of ILS 107 per square meter (sqm.) for fitted-out space and occupancy rates remained stable since the end of 2019, at about 94 percent. It was seen that 2020 will be a stable year in this regard, with 134,000 square meters that are expected to enter Tel Aviv CBDs, compared with about 222,000 in 2021, against an annual average Take-Up rate of about 130,000 sqm. This is in addition to interesting fluctuations concerning the acceleration of the trend to promote mixed use rights.

From the outbreak of the pandemic until now* we have seen:

- A standstill among companies that were to begin moving to new offices prior to the outbreak, totaling more than 30,000 square meters.
- The inception of new processes, whether for renewal, growth or downsizing, streamlining rental costs and more, totaling more than 85,000 square meters.
- Progress and completion of processes during the COVID-19 crisis (some began beforehand and continued until completion, while others began and were completed during the crisis) totaling about 60,000 square meters.
- Subleasing. We foresee an increasing trend of large tenants acting to reduce the areas that they rent. It will be interesting to see whether these are isolated cases with short-term implications or a trend and to what extent it will have an impact on future rentals. Example sublease transactions reviewed to this point (mostly for a period of up to 3 years) include offering about 50 percent of the rented areas at a rental level of even 30–40 percent less than the actual rent paid by the direct tenants.

* Data gathered from March 15, 2020 to July 15, 2020.

Decline in rental prices? And what about the assessors?

In determining the level of rentals, there is a clear distinction between leading developers who have whole projects (single ownership) and smaller property owners, who are part of a purchasing group (multi-owned projects). Leading developers have the ability to see a few years beyond the horizon, therefore show no “pressure”.

For most Class A office space, there was a minor decline of about 5-10 percent in asking rents and here too these are specific cases by project, quality of the property and duration of the rental period. In most cases, a significant reduction in rent is not on the table, but rather benefits such as extending the grace period, a lower coefficient for calculating the fit-out works budget, a readiness for more flexibility in the lease framework and so forth.

The real distress is among owners in multi-owned projects. Where a surplus of space was observed before the COVID-19 crisis, particularly in the BBC (Bnei Brak Business Center) area and in Petach Tikva, owners had already lowered prices. Now, when competition over small tenants has increased, there is further distress, with a readiness to lower price by even up to 40 percent then the asking price listed in the end of 2019. The most significant declines over the last 6 months were indeed along the BBC route and in various multi-owned projects throughout the country.

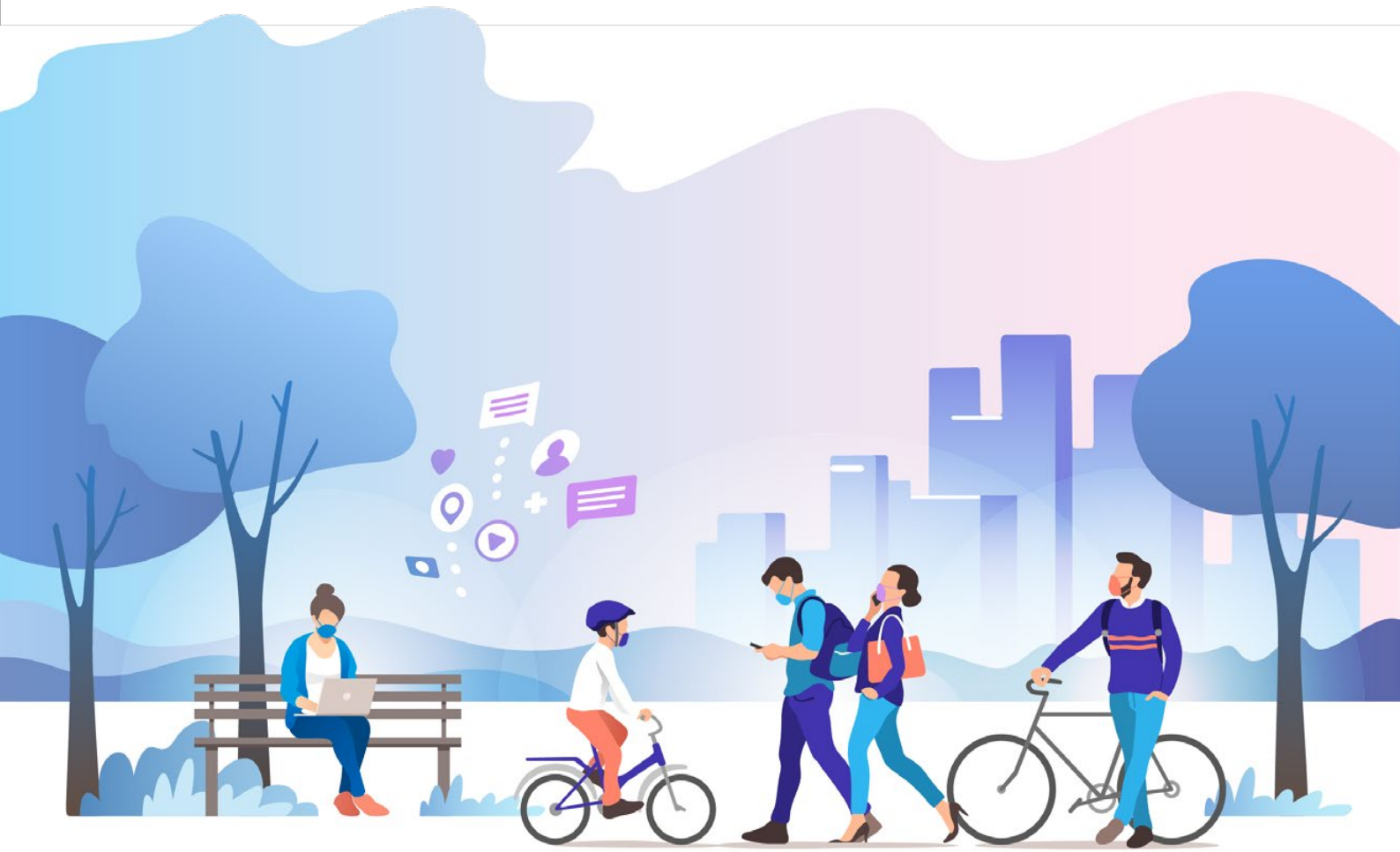
A conference held by Alrov Real Estate Research Institute showed that the value of properties owned by income-producing real estate companies is expected to decline due to the COVID-19 crisis. In the opinion of the participants, old office buildings, income- producing real estate that generally have a high number of owners and properties rented to small tenants with little financial security on short-term rental agreements, are expected to suffer from an increase of up to half a percent in their capitalization rates.

Working from home, or from any place?

Executive surveys carried out by Gartner and Microsoft found that about 82 percent of companies plan to permit remote work at least for part time even after the crisis passes. About 47 percent say that they plan on allowing full remote work.

There is a long list of advantages to working from home: convenience, greater efficiency, saving of travel time, creating a better balance between work and personal life, an increase in productivity and savings in office expenses. **In contrast, there is also a considerable list of disadvantages:** lower motivation over time, mixing work time with household tasks and creating longer-than-usual work days, background noise and unsuitable infrastructure, difficulty in maintaining company's identity and values among employees, difficulties in training employees, social isolation, harm to creativity and brainstorming and more. In addition, there have recently been an increasing number of statistical data showing that the important place of infection is at home and not at beaches, restaurants and workplaces.

One should remember that **in the end, people do business with people**, regardless of where they work. As such, weighing all of the above, it seems that finding the balance will be translated into more flexible “hybrid work”, which combines working in a physical and virtual environment and enables work from any place in order to provide flexibility and employment variety, as well to protect employees’ health. Accordingly, it seems that we will see increasing demand for field offices (business centers for flexible rent) to join to headquarters, together with changes in space in residential buildings.

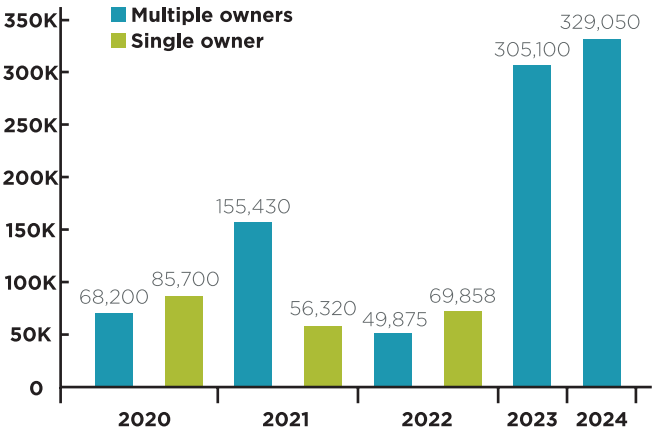


Surplus offices?

In the next five years (2020–2024), the market for offices in Tel Aviv CBD thoroughfares and its neighboring cities - Givatayim, the Diamond Exchange District in Ramat Gan and the Ramat Hachayal area, should absorb the entry of about 1.1 million square meters. Another 320,000 square meters are due to enter the BBC district alone.

By distribution, a majority of the office areas due to enter Tel Aviv CBD and its neighboring cities —roughly 80 percent—are owned by single owners. In the BBC they include around 60% of the areas. **Of all single owned office space expected to enter the market by the end of 2021, more than 75 percent is already occupied in the Tel Aviv CBD and its neighboring cities, compared with just 35 percent in the BBC.** Likewise, as of now, no decision has been made to stop construction in projects that are expected to enter the market by 2023. However, there may be construction "stoppages" in the future (similar to the construction "stoppages" that took place in the office field during previous economic crises).

Forecast of Additional Office Space (sqm.) in Tel Aviv CBD*



* Including the Diamond Exchange district and Ramat Hachayal, but not including the BBC site in Bnei Brak.

Where are investors headed?

Hot, Hot: Logistics, data centers and life sciences: Even before the crisis, demand for logistics centers around the world showed strong growth, partly due to the constant increase in online sales, which grew by about 10 percent per year and totaled about $600 billion in the US alone in 2019—more than 16 percent of US retail sales.

The data center field, which combines technology and income-producing real estate, has also attracted high demand, which has grown in recent months. Internet use continues to skyrocket, work from home has become standard and the use of social networks, online purchases and streaming services have grown by dozens of percent—while the almost absolute transition of organizations to the cloud is contributing to immense demand in that regard.

The life sciences field has also grown in the recent period and the Startup Nation organization notes that as early as March, there were 70 companies involved in the area of treating the COVID-19 crisis alone and that there are currently more than 250 startup companies that have rapidly changed direction to this matter based on their existing technologies.

The Wall Street Journal also notes that the COVID-19 crisis has turned out to be a positive economic development for those renting out office space to biotechnology companies, pharmaceutical companies and others from the life sciences fields: "Property owners have already done a lot of business with companies working on medical solutions to diseases such as diabetes and cancer. They are now seeing strong demand from companies that are working to develop medications and vaccines for COVID-19. While the work from home policy is eroding demand for office space, laboratory work, particularly in the life sciences field, can generally not be done remotely."

Looking forward

Rise in Importance of the Suburbs?

There is a growing assessment in the world that the office market in peripheral cities will be rejuvenated. We can't know how long the COVID-19 cloud will linger over us, but if many employees continue to work from home fully or partially, this could lead to greater demand for office space that is not available in the typical residence with all the complexity regarding separation of the work space and day-to-day household issues and the accompanying background noise. In addition, there is concern regarding infection on public transit, so doing away with all the problems of transportation and traffic delays will also play an important role.

In terms of the employed persons' market, our assessment is that as Generation Z and the Millennials take on a larger share of the labor market, the occupancy of field offices will increase for work that they cannot permanently do from home since they generally live in small apartments with a variety of apartment-mates, combined with the fact that many of them have gone back to living with their parents. This is without taking into account the argument of lowering rental expenses. Prices in the outlying cities are lower and the opportunity of opening a more varied employment market makes it possible to recruit workers without the geographic dependency of offices.

Another field that has made headlines due to the COVID-19 crisis is the serviced office spaces, which seemed to have experienced great difficulty particularly at the beginning of the crisis. In contrast and in the context of the expected increase in demand for field offices, the expectation is that in Israel, similar to what is happening abroad, we will see a greater number of serviced office spaces that will enter under this need.

In addition, we expect a change in the density coefficient compared with what we have seen in joint office spaces until now. In the operators' new centers in Israel, we have reached about 5 square meters per worker—an unprecedented number compared with the traditional number of about 12 square meters per worker in standard company offices.

Wellness and Welfare; Green construction and a healthy environment or a technology boom?

It has already been a number of years that the wellness and welfare fields have taken a broad place in companies' considerations when choosing office space. Their significance may increase due to the crisis.

On one hand, projects that meet green construction standards bring value to companies through cost savings, to employees through a healthier environment and to developers through high-quality tenants. Whilst it is true that green construction standards in Israel and internationally (LEED) change from time to time, they are centered around the importance of green environment alongside the quality of a broad, healthy environment issues that have made headlines during this period.

On the other hand, assessments abroad are now, as a result of the crisis, talking more and more about technological construction. Developers will need to consider their mix of investments between spaces for the wellbeing of companies and workers, which were their pride up until now (conference halls, fitness rooms, shared lounges, green areas and renewable energy components) and the need and demand for smart buildings with a variety of touchless technologies that will require considerable investments from developers.

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Every median, our research department reviews the trends of the office market in Israel and around the world.
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