The modern office conundrum
Private Debt Investor
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3 February 2025

Featured

The modern office conundrum

With working patterns, and therefore real estate requirements, transformed in the long term by the pandemic, how are real estate debt investors approaching office opportunities now?

Jon Yarker · 11 hours ago

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Even five years after the onset of the covid-19 lockdowns, investors and managers with office real estate portfolios are still grappling with the changes they sparked to office working patterns.

In the years since employees were suddenly forced to work from home, many employers have come to realise that their legacy offices are no longer fit for purpose.

According to a recent report by the UK Office for National Statistics, more than one-quarter of adults across Britain still use a hybrid working pattern, while the Chartered Institute of Personnel and Development reports that 74 percent of employers advertise some jobs as being open to flexible working in an attempt to attract top talent. But what has this sea change meant for traditional office assets and the lenders seeking to meet investor demand in this evolving working environment?

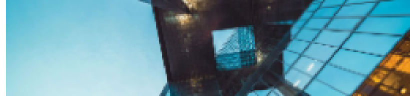
"We've been witnessing the 'death of the traditional office', making it more challenging for developers to prove ongoing demand to secure lender-approved valuations," says Kimberley Gates, director of client partnerships at real estate lender Karis Capital. "To entice people back to the office, spaces now need to offer more than just desks, microwaves and water coolers."

Demand for modernity

Ben Barbanel, head of debt finance at OakNorth Bank, has similarly seen borrowers' priorities change, with a surge in demand for modern, more environmentally friendly buildings with strong credentials. This, he explains, can often result in tenants taking on large spaces so that they can offer more comfortable square footage per employee.

"This 'flight to quality' is driven by a desire for better amenities, appealing design, flexible layouts, rooftop terraces and premium end-of-trip facilities, as well as an increased focus on sustainability," explains Barbanel. "This is why flexible offices are generally doing well, as they have lots of breakout areas, private booths, coffee areas, canteen areas, gyms, bike stores, changing rooms, etc."

Meanwhile, Hans Vrensen, head of research and strategy at AEW Capital Management, projects that European office markets will recover in 2025 – specifically, he expects vacancy rates to fall as supply of new space reduces.



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"In fact, over the next five years we project office vacancy rates to come down to 7 percent," says Vrensen. "However, the loan margins for loans on office collateral remains elevated compared both to its historical level and compared to other sectors, like logistics."

New valuation considerations

Amid shifting office demand, and with many employees having now returned to the office in a hybrid capacity, questions are now being asked about what investors see as the most valuable assets on offer.

According to Sima Kotecha, head of high yield strategies for real estate debt at Aviva Investors, prime assets are attracting the most attention from a debt perspective, and she has seen "significant value adjustments" in this area.

"The transactional evidence for less prime assets is somewhat limited," adds Kotecha. "For such assets, we think the focus should be on what the medium-term occupational demand will be, the likely payback period on any capex requirements, or indeed whether there is potential to convert to other uses."

Indeed, Karis Capital's Gates explains that offices that offer modern amenities are becoming more attractive in the post-covid environment, with location and square footage less likely to be the key determinants of value. She explains that this shift is about creating environments that will encourage people to visit offices more often.

> *"Anything that is not a prime product in a strong location feels unnecessarily risky"*
>
> *Vincent Nobel*
> *Federated Hermes*

"From a debt perspective, lenders are increasingly focused on assets that can easily be repurposed to meet changing demands," adds Gates. "Developers looking to secure finance must be able to demonstrate the long-term viability of their assets, and their ability to adapt to evolving market conditions."

OakNorth's Barbanel adds that factors such as yield shift and small changes in rent can have a "huge impact" on an office's value.

"Offices have definitely been over-leveraged in the past," he says. "A big challenge for many at the moment is that at lease expiry, tenants have a lot of choice and the ability to upgrade to better space, so unless an office is 'Category A' in a top location, it's hard to compete."

Indeed, for decades, real estate debt portfolios have thrived off city-centre assets, with managers safe in the knowledge that location alone would help to ensure rental income kept flowing in. This change in working patterns has not only hit valuations – it has also made it harder for some investors to get involved in this space. Offices in prime locations are now more expensive to acquire and maintain, while their ability to attract tenants remains uncertain.

Vincent Nobel, head of asset-based lending at Federated Hermes, is seeing the same trends, but adds that for many, this will be a challenging adjustment to make. "Many investors are still nursing their wounds from the heavy valuation declines in offices," says Nobel. "For them, it may be hard to step back in. It requires full conviction when other offices in the portfolio are held 50 per cent below their peak values from just a few years ago."

Despite this being an "interesting point in the cycle" to consider market re-entry, Nobel says that "the investable universe has shrunk considerably". "Anything that is not a prime product in a strong location feels unnecessarily risky."

One of the most challenging aspects of office investments is the fact that while offices may be largely empty of workers for part of the working week, they sit within an investor's portfolio year-round. This disparity between tenants' needs and investors' expectations is causing consternation around depreciation deadlines.

"The change in how we use offices, with a typical occupier using less space but requiring that space to be of higher quality, has the potential to speed up the depreciation of these assets, with refurbishment or redevelopment cycles becoming shorter," says Nobel, who explains that financing therefore requires higher amortisation rates or lower leverage. "This is in effect a lower availability of debt, which may put further downward pressure on asset values, particularly in an environment where that debt is still relatively expensive."

Meeting tenants

Investors and lenders alike are coming to terms with the changing office requirements, though it has required a re-education of sorts for many. Christopher Stallard, relationship director of property finance at Leumi UK, says it has been crucial for his team to meet with tenants to understand exactly how they want to accommodate hybrid patterns, and what this would mean for his own team's objectives.

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>
> *Kimberley Gates*
> *Karis Capital*

"This may impact our view on forecasting renewal or breaks being exercised," says Stallard. "What's also clear is that the vast majority of leasing deals are for less than 10,000 square feet, and it is these unit sizes that are most in demand, meaning the make-up of available space is a material factor in forecasting voids and rent-free periods."

Karis Capital's Gates has also experienced a greater push for lenders to show more flexibility and reflect more nuanced demands from borrowers in the office sector. "We're seeing more interest in short-term, flexible loans and refinancing options for properties that cater to co-working, shared space, or mixed-use environments that can cater to a wider range of tenant needs," she says.

What is the outlook for 2025?

Aviva Investors' Kotecha says such prime assets will likely continue to be a focus for investment-grade strategies throughout 2025 but adds that there is scope to generate value elsewhere.

"It's an exciting time for our higher-yielding strategies as we have the opportunity to work with sponsors to finance assets which perhaps are not prime today but will be in the future, and we can look to improve the sustainability credentials of the asset through funding the development and/or repurposing of these assets," she says.

Investing in refurbishments to bring office real estate in line with modern working requirements is likely to be a growth area, with construction data provider Glenigan forecasting an 18 percent surge in such projects throughout 2025.

Many asset owners with empty properties may be forced to renovate in a bid to attract tenants, and Karis's Gates says this could have an impact on how debt is structured.

"From a debt perspective, it is likely loan-to-value ratios will remain lower and interest rates higher," says Gates. "Lenders will remain cautious but will be open to backing assets that have a clear, adaptable strategy. Developers will need to demonstrate the ability to meet these new demands if they want to secure funding."

OakNorth's Barbanel is already seeing more investment opportunities to reposition office assets, but adds that this is not restricted to the largest city centre properties and instead reflects new working patterns.

"We're also seeing quite a few operators looking for funding to build smaller offices of around 300 square feet or commercial units in more regional, remote locations," he explains. "This is because there are tenants who don't necessarily want the cost or time of commuting into a major city, but still want somewhere separate from their home to go to work."