Commercial leasing: Back to office reality

Indian Economy

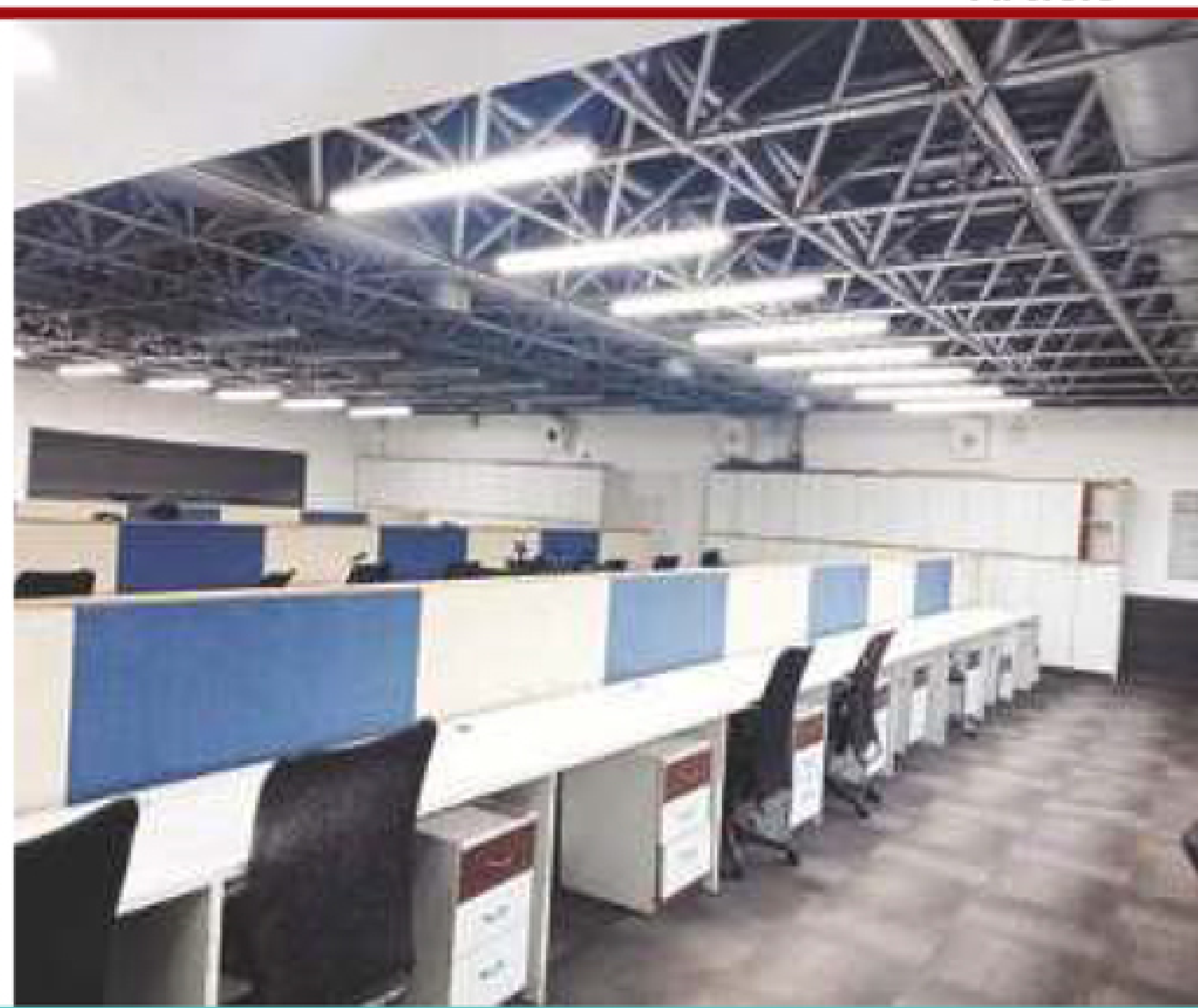
Driven by geo-political tensions and pandemic induced restrictions, India's Gross Domestic Product (GDP) grew at a sub-par rate of 8.70% in FY22 (FY refers to the period April 01 to March 31). However, it recorded growth of 13.50% in Q1FY23 (y-o-y), up from 4.10% in Q4FY22 (y-o-y). The high GDP growth in Q1FY23 can, in large part, be attributed to the favourable base. All three major sectors – agriculture, industry and services – witnessed a loss in momentum compared to the previous quarter. When compared with the pre-pandemic period of Q1FY20, GDP has recorded a modest growth of 3.8%.

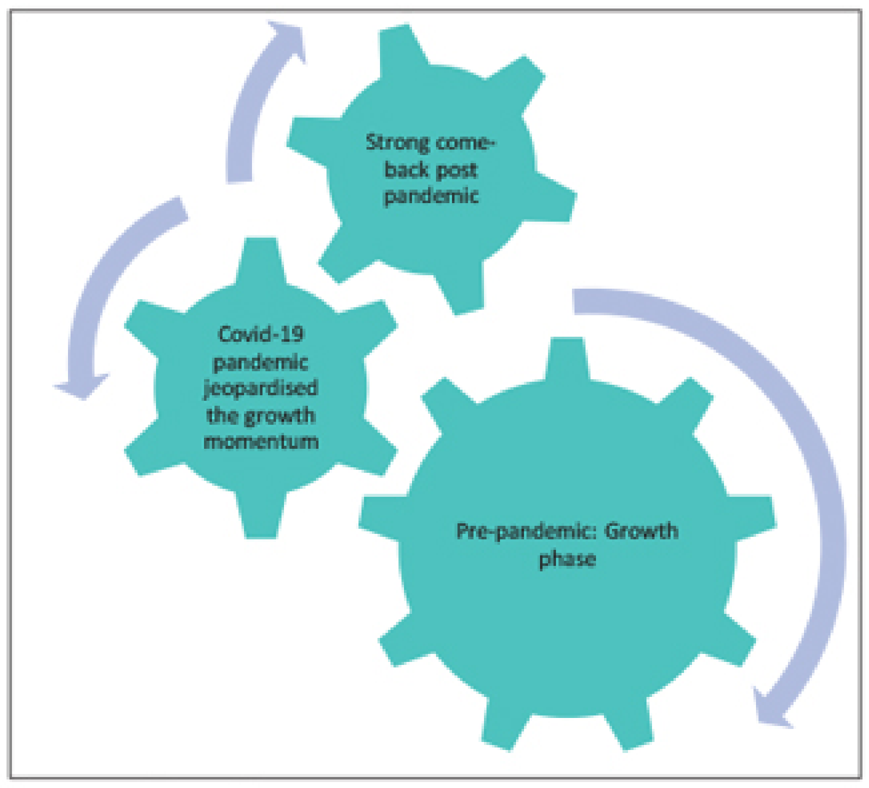
Source: Ministry of Statistics and Programme Implementation (MOSPI), CareEdge

Although green shoots are visible on consumption and investment front, we need to be wary of the economic slowdown and its implications on the Indian economy in the coming quarters. CareEdge expects, normalization of monetary policy and weaker external demand weighing on economic activities. Hence, CareEdge has revised its GDP growth projection downwards to 6.80-7.00% for FY23 from earlier projection of 7.10%. The sovereign outlook though remains stable with a view that the impact of Russia-Ukraine conflict, rising inflation and deterioration in global economic health is improbable to derail India's ongoing recovery from the pandemic in 2022 and 2023. Strong economic fundamentals, higher capital buffers and adequate liquidity are factors which are expected to withhold the Indian economy.

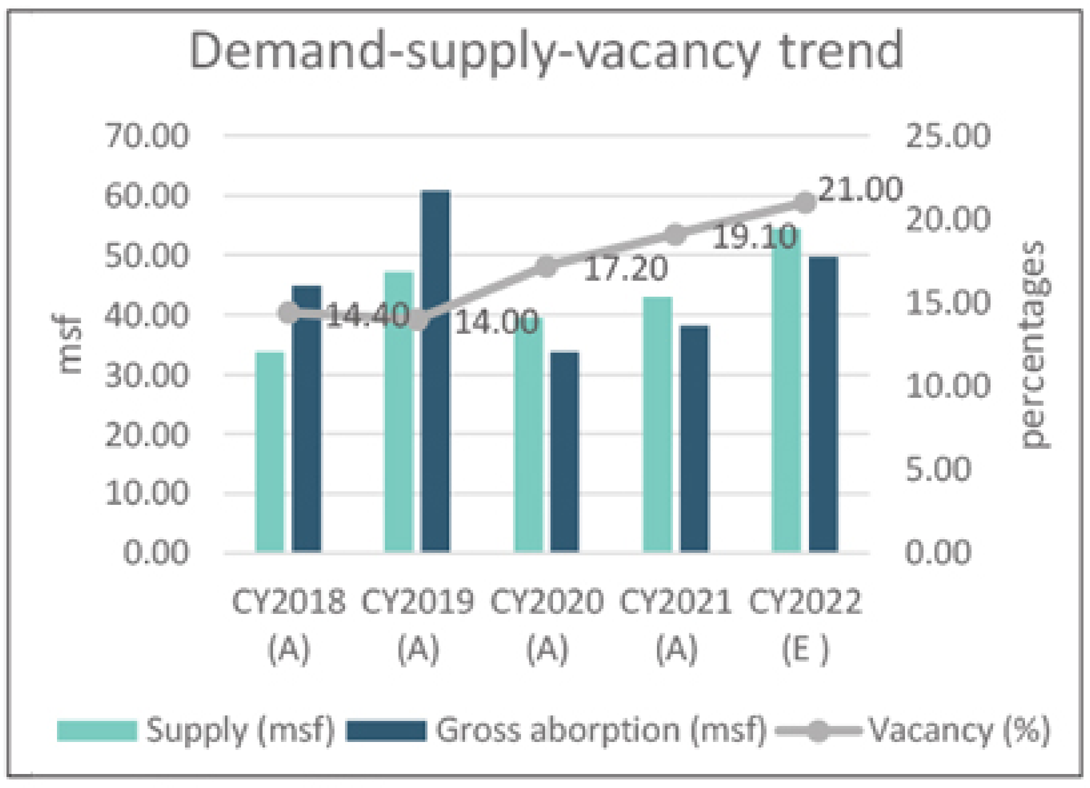
Indian commercial real estate market

Pre-pandemic, the Indian office real estate segment demonstrated remarkable growth for three years. Covid-19 pandemic stalled the growth momentum which impacted the Indian office space market steeply. Post-pandemic, new completions and absorptions witnessed a recovery across 7 key geographies (Bengaluru, MMR, NCR, Chennai, Hyderabad, Pune, and Kolkata).CareEdge observed, though the developers offered some relief to occupiers by way of rent deferrals, camp discounts of 2-3 months, etc, thereby reducing their overall rental outflow burden, the rental rates remained stable. Large players with





Source: CareEdge



Source: Embassy REIT

strong liquidity, having diversified portfolio of assets and low leverage, were less impacted by the pandemic.

Hence, there have not been any major rating downgrades in the office space leasing segment in CareEdge Ratings' portfolio since the pandemic. It is also noted that leasing culture is taking up a new shape wherein with hybrid working model setting in, large business operators are inclined toward shaving office at a single prime location of the city with limited seating arrangements and closing down offices from various locations.

H1CY22 (CY refers to the period January 01 to December 31), reported strong comeback marked by highest quarterly leasing in Q2CY22. CareEdge has observed that back-to-office though in hybrid mode by the Information Technology (IT)/ Information Technology enabled Services (ITeS) and robust hiring has resulted into pent-up demand of office spaces in key cities. Net absorption in Q2CY22 was nearly 197% up y-o-y while new office completions was lower by 11% y-o-y. Bengaluru led the market witnessing highest number of new leasing activities in Q2CY22. The city also recorded highest major office transactions and is leading the pan-India absorption at 33% share in H1CY22 (Source: Embassy Real Estate Investment Trust (REIT)).

Rise in absorption coupled with lower new supplies in Q2CY22 has resulted into lower vacancies driven by key markets, Mumbai, Chennai, Kolkata and Pune.

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During H1CY22, IT/ITeS sector, E-commerce and banking, financial services, and insurance sector (BFSI) reported an increase in the leasing activities. Yet IT and ITeS continued to drive office space demand in the country followed by manufacturing/industrial sector. A shift in demand for office size was noted wherein small sized occupiers (<0.05 mn sqft) contributed higher towards absorptions. CareEdge notes that properties operational for more than 8-10 years may witness risk of vacancy and lower than micro market rentals given new supplies.

Flex workspaces: The pandemic opened roads for flex workspaces (workplaces to suit the objective of the occupiers). Of the key geographies, Bengaluru market is leading the culture with other major contributors like Hyderabad, Delhi/NCR, and Pune. Based on CareEdge's interaction with market players; given the demand, supply in H1CY22 has reached 75% of full year CY21 flex stock. The distribution of flex space is skewed towards new business districts (NBDs) followed by central business districts (CBDs) and peripheral. The pricing perspective, mobile workforce, access to new talent pools are the driving factors for tier 2 and tier 3 cities to be new home for flex operators.

Non-tech industries including BFSI, consulting and telecom, media and healthcare segments are likely to drive the demand of flex office space in near to medium term though may remain dominated by IT/ITes. CareEdge notes, that start-ups have been leading the flex space leasing activities. The operators have now realised that flex workspace is cost saving with limited capex, time saving with ready availability, short to medium term availability and well suited for smaller teams.

Investments in sector: The uncertainty caused due to the pandemic Covid-19 has shaken the confidence of the investors evidenced from Q-o-Q fall in foreign direct investment (FDI) equity inflows. Interestingly, domestic investors have presented a strong come back in the market accounting 38% share in total investments in H1CY22 and expansion by 13% to reach USD2.6 billion compared to same period previous year (Source: Industry news). Investors are now positively looking at the real estate segment of which office space has driven the investment inflows accounting 48% of the total inflows. This is followed by the organised retail sector contributing 19%.

Outlook: CareEdge believes, office leasing segment is likely to remain stable induced with many positive developments upcoming in the sector. New office completions and absorption metrics is expected to improve in near term with pandemic receding and business resuming to normalcy. Rental rates though monitorable, are expected to remain stable given higher vacancies and corporates moving to tier 2 and 3 cities to decentralise. Further, despite the backdrop of ease in exit to investors, the investment in the sector is expected to rise. Market has demonstrated healthy take away to investors in real estate sector, particularly (REIT).

In terms of end user industry, though non-tech sectors are witnessing rise in various parameters, dominance of IT and ITeS is expected to continue in leasing activity over medium term due to massive business accruals post second wave of the pandemic, return of employees to their workplaces though in hybrid mode, social distancing norms resulting in de-densified office spaces, etc, are expected to influence the demand positively.

The sector was one of the fastest to recover from the impact of the pandemic and is projected to reach 1.2 billion sq ft valued at $ 165 billion across 7 key markets by 2030 (source: Industry news). However, inflation control measures by RBI may further rise the interest rates on debt resulting into dilution of profitability which cannot be neglected. Interest rates may remain monitorable over medium run.

CareEdge understands that large occupiers are expected to drive the leasing activity given their plans on expansions. The co-working space is expected to grow at 20-30% in terms of seat absorption as companies adopt the hybrid model of working. Grade-A properties with superior infrastructure are expected to exceed 700 million sq ft with Delhi / NCR having largest share of the pie, as occupiers focus on sustainable workplaces. Overall credit profile of organised developers/ institutional players is likely to remain stable for office spaces particularly large players owing to Grade A assets. The visible rise in demand is likely to push the supplies over medium term. EPC World

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