DISCUSSION THREAD
Digital Forum for Community & Conversation

EVALUATING THE FUTURE OF OFFICE

By Antonio Lulli

Bloodbath and Beyond
Everyone has seen the headlines predicting the "death of the office" or something to that effect. These claims ring true from a common sense perspective; we can see with our own eyes how more and more people decline to attend the office and choose a remote lifestyle. This headwind for the office market is now being significantly exacerbated by the unprecedented speed of monetary tightening and a possible recession looming . Further, countless articles and papers have emerged that add substance to the analysis of this phenomenon. Below are some of the greatest hits:

- NYU and Columbia faculty researchers predict the remote work phenomenon will lead to an "office real estate apocalypse", causing a 39% decline in long-run value, which translates into $413 billion of value destruction.
- Cushman & Wakefield anticipates office values to decline approximately 50% by 2026 in their downside stagflation scenario.
- In a separate report, Cushman & Wakefield expects up to 25% of U.S. office stock, or about 1.4 billion SF, to become functionally obsolete by 2030, while 1.1 billion of it will be vacant.
- Green Street estimates (base case) that there will be a 15% decrease in office demand in the US

While distress in the market has been slow to materialize due to the long-term nature of most office leases, we are beginning to see some distress emerge.

Clearly, all the data points in one direction, so my goal here is not to argue that the office market writ large will be a bed of roses. Rather, it is a reminder that with every downturn comes opportunity, and that there is a case to be made that for at least a segment of the office market, the best may yet be to come.

Capital Punishment
The pessimism illustrated above is already being felt in today's capital markets. Investment and transaction volume for office assets decline 66% YoY to Q4 2022, dropping from $55.2B to $18.7B nationwide.

This is being driven in large part by the upward shift in interest rates and subsequent tightening of credit conditions, which is being felt most acutely in the commercial real estate (CRE) sector. As 15% of outstanding CRE debt comes due in 2023, Moody's Analytics estimates that up to 40% of it will struggle to be refinanced . This is sure to cause significant pain for lenders and investors alike, and office assets stand to be particularly affected. Anecdotally, even well-leased offices with good weighted average lease terms (WALT) are facing difficulty in the financing market, with a Trepp executive saying that bringing an office loan to credit committee represents a "career risk" in the current market .

Valuations are tied to the current lack of liquidity and there is currently a lack of visibility due to a lack of trades and price discovery, they are certainly already adjusting downward to reality. Imputed values, (as implied by REIT market value vs. net asset value (NAV) calculations), are suffering from steep discounts, up to 38.4% as of Feb. 1, 2023 (see Exhibit 2). Meanwhile, cap rates are expanding significantly across markets, even including Gateway and Sunbelt markets (see Exhibit 1), long considered safe havens for CRE investment.

This will likely be exacerbated in the short term by the recent rounds of layoffs, the widely predicted recession, and now the sale of distressed bank CRE assets.

A bit of perspective is needed here. We are unlikely to be facing a repeat of a 2008-style collapse due to much more conservative underwriting and more robust financial institutions, but there inevitably will be a valuation paradigm shift in the CRE industry reminiscent of the early 1990s.

Market	Class A Stabilized H1 2022	Class A Stabilized H2 2022
Baltimore	-	7.75% - 8.5%
Boston	5% - 5.5%	5.5% - 6%
Hartford	-	10% - 11%
New York City	5% - 5.25%	5.5% - 6%
Philadelphia	6.5% - 7%	7% - 8.25%
Pittsburgh	7% - 7.5%	7% - 7.75%
Stamford	7.25% - 7.75%	7.5% - 8%
Washington, D.C.	5% - 5.5%	5.5% - 6%

Exhibit 1
Source: CBRE

Office cap rates are expanding and even high-demand Sun Belt markets are affected.

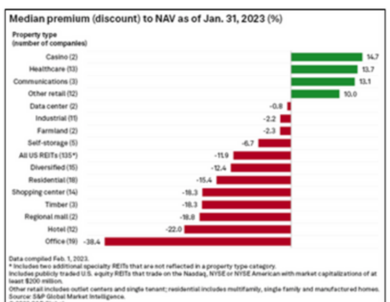

Exhibit 2
Source: S&P Global

The markets are very negative on office REITs, which are trading far below their NAV.

A Split in the Road

Before we go any further, we have to address another key dynamic that is emerging in the office market: there is an appreciable bifurcation in the market driven by a "flight to quality" phenomenon that is driving a gap in rents that will only continue to widen over time.

While office demand overall is expected to decline significantly, older, underinvested properties will bear the lion's share of that downside.

Newly built or renovated buildings in gateway cities with ample amenities and good access to transit continue to perform as the work-from-home (WFH) frenzy means that employers face a tougher hurdle in bringing their workers back to the office and so are not being shy about paying mouthwatering rates for the top of the line workspaces that will entice their talent back. Compared to 2019 levels, Class A (60%) has demonstrably higher utilization rates than Class B (53.6%), and even more dramatically so for Class A+/Trophy assets (66.3%). For that reason, 73% of Manhattan's office leasing activity has taken place in trophy and Class A space since the start of the pandemic. In fact, more leases over $100psf were signed in 2021 than any year before the pandemic, while the $300psf mark was surpassed for the first time at SL Green's 1 Vanderbilt.

This structural shift, coupled with increasingly stringent environmental requirements on the part of investors and authorities alike, is driving the more generic Class B and C stock into "accelerated obsolescence" , increased difficulty in capturing demand, and a corresponding cratering in values. Some will continue as zombie properties with chronically high vacancy, others will be converted to alternative uses, and the rest will languish.

Penny Wise, Pound Foolish

Another thing to consider is what truly drives a firm's profitability and the relative value of any potential office rent savings in that framework. Human capital is any firm's lifeblood, and so it is their main responsibility to ensure that their workforce is productive and content with their circumstances.

Payroll is also often a company's largest expense category. In fact, Fortune 500 firms spend between 50% to 60% of their annual spending on compensation.

By comparison, rent expense (which includes non-office leases, equipment leases, and other related costs) accounts for only 3% of operating expenses for S&P 500 financial services firms, slightly just over 3% for tech firms, and 2.9% for the index overall. This figure shrinks to 1.9% when calculated as a percentage of adjusted net revenue.

If reductions in office space have even a marginally negative impact on productivity, one could conclude that such a move would be a net negative for the firm, regardless of actual savings on rent expenses. As Scott Rechler pointed out in a recent webinar with GreenStreet, firms are currently looking to drive up office usage rates by making spaces more attractive, being more intentional about mentorship and collaboration, and incorporating health and wellness priorities into the workspace.

All this is to say that it is far from certain that reducing office space in the wake of the remote work fever is conducive to long-term benefits for firms, and it is this writer's belief that forward-thinking organizations will realize this reality and re-prioritize offices in their workplace strategies.

Zooming Out

It is a minor miracle that most firms were able to operate relatively smoothly with virtual-only tools for an extended period, and we should be thankful that many were able to sustain their livelihoods remotely during this once-in-a-generation health crisis.

A few years later, however, some evidence of the longer-term outcomes of entrenched remote-work culture are starting to become apparent, and there appear to be some serious downsides.

Some have identified a "Zoom Ceiling" for those working remotely. Regardless of the merit of such perceptions, it is becoming clear that remote workers are less likely to be promoted given the same or equal productivity, sometimes up to 50% less so. Further evidence points to a feeling of disconnectedness, especially for younger or new employees. Losing out on opportunities for learning, interaction, mentorship, networking, and general relationship-building can be very detrimental, especially early in one's career, and even productivity can suffer. Early in 2022, 74% of poll respondents asserted that they missed having an office community. As Scott Rechler put it: "The benefits of being physically present for one's career advancement will become more apparent over time". There is growing evidence that younger workers in particular are keen to return to in-person work.

In an extreme case that will fuel the back-to-office movement, remote work and a lack of in-person collaboration have even been partially blamed for major risk-management oversights and subsequent collapse of Silicon Valley Bank.

The Future

Momentum has started to shift, as companies are taking notice of the dynamics explored above. They have begun to aggressively reduce the proportion of remote-only job listings or stepping up the in-office days for hybrid workers. In many cases, this hasn't affected talent retention.

This writer doesn't believe that remote or hybrid work will ever fully go away, but fully remote companies will struggle in the long run, especially during trying periods, as they suffer from a lack of cohesion stemming from some of the factors outlined in previous sections. Even the COO of Salesforce, long one of the most strident advocates of remote work, is urging more in-person work, citing a productivity drop among those working 100% remotely. He said: "When our people are together, they're better learners, collaborators, and networkers. It also reinforces performance culture".

Overseas locations are far ahead of the US in return-to-office rates. Europe and the Middle East range from 70% to

90% of pre-Covid utilization levels, while Asia hovers between 80% and 110%. While the United States has structural headwinds to achieving these heady rates, it is reasonable to conclude that there is significant room to grow from the current occupancy rates of 40% to 60%.

Also, less time in the office does not necessarily equal a smaller footprint. Modern floor plans that minimize space per employee, often using hot-desking or other efficiency-driving techniques, are not conducive to making people want to come in because it gives workers a very transient feel that doesn't support the collaboration and other positive aspects of physical presence.

In summary, office utilization may never hit 100% of pre-Covid levels in the U.S., but this likely won't result in as catastrophic a decline in office demand in the long run as most analysts seem to expect. JLL's CEO agrees, stating that he doesn't see companies shrinking their office space, but "changing how it is used".

The Next Buying Cycle

The concept of offices experiencing an existential crisis in the face of the WFH phenomenon, and as such is predicted to have a cratering of structural demand. For the reasons outlined above, I do not believe this will be the case to the extent the market seems to imply.

As such, I think the valuations are being excessively downgraded in the current market. This is likely to worsen as CRE mortgage debt comes due in the next several quarters and sponsors are unable to roll over their debt, causing banks to take over the properties and sell them at steep discounts. Despite likely difficulty in obtaining financing, a significant opportunity will open up during this downward cycle for well-capitalized investors willing to stake out a contrarian view. There will certainly be turmoil in the short and possibly the medium run, but assets of varying quality and future viability are being painted with the same broad brush, which will lead to opportunities for those who can identify this market dislocation.

As such, opportunistically acquiring distressed office properties at an attractive basis will prove to be accretive in the long run,

Only 15% of the national office stock will be considered newer, while 60% will need upgrades to avoid obsolescence. As such, older vintage Class A stock in prime urban locations that have the bones to support a modern workplace with moderate capital investment such as outdoor spaces, exercise facilities, quality food options, tenant programming, lobby upgrades, and/or new ventilation systems. Similarly, there may be opportunities to target capital injections (preferred equity, mezzanine, or other creative solutions) in insolvent properties with good fundamentals. This is particularly true of Sunbelt and Gateway markets, which are expected to make the strongest recovery.

Further, the challenging market environment is likely to significantly depress the upcoming pipeline of office projects, as evidenced by the recent high-profile postponements of such developments by major players. This will further support the viability of upgraded vintage stock in the medium term. Scott Rechler expects trophy properties to be trading in the 5% cap rate range within a couple of years once the markets unfreeze, so the current motto is "Survive to 2025", in a nod to Sam Zell's famous retort in the 1990s.

In contrast, functionally obsolete stock away from prime locations is likely to continue a downward trajectory despite significant investment and thus should be avoided except as conversion opportunities or other creative approaches. Expect this divergence to play out similarly to the fundamental revaluation shopping centers underwent as an asset class in the last decade, with high-end assets in top-tier locations not only surviving but outperforming, while more generic stock in weaker markets has quickly become obsolete and is being converted to other uses en masse .

Discussion Question:

Do you agree with the analysis above? What do you think will happen to office as an asset class in the medium and long term?

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