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# NAREIM dialogues

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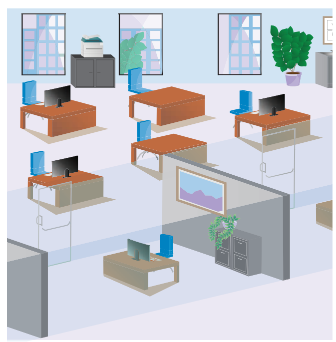



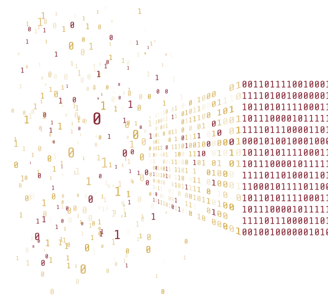



Q&A

# The STATE of the office

**NAREIM speaks with Preston Sargent, Executive Vice President at Bailard, about office opportunities amidst changing work trends in the post-Covid-19 world.**

**We're in the middle of a pandemic and some headlines say office is dead. What are you seeing with demand?**
Office is definitely not dead. But because the economy is contracting, demand for office space is negative for the first time since the first quarter of 2010. Negative absorption during Q2 2020 was approximately 20 million square feet (msf). In the context of an 8 billion sf market, 20 msf is fairly inconsequential. However, if negative absorption persists while new space is being delivered, vacancies will tick-up and rents will be under pressure.

Previous recessions are not particularly helpful in understanding the contours of this current contraction, its impact on real estate fundamentals, and the timing and trajectory of a recovery. However, the recession triggered by the 2008 Global Financial Crisis (GFC) is a useful benchmark. Over a seven-quarter period during the GFC, there was 56 msf of negative absorption, an average of 8 msf per quarter. The highest quarterly negative absorption during the GFC was Q2 2009, when it hit 20 msf.

We believe the economic recovery from this pandemic will be slow, halting, and muted, and for that reason anticipate several more quarters of negative absorption before positive demand returns. Many companies, large and small, public and private, are looking to save money. This could translate into looking for ways to lower occupancy costs by shrinking their office space footprint by allowing employees to work from home, moving to less expensive space in lower quality buildings, and/or relocating to a different submarket in a metro area or an entirely different market altogether. All of this will take time to play out.

Although we don't foresee wholesale migrations from central business districts (CBDs) to suburbs, or from expensive global gateways to more economical metro areas, on the margin there are several pro-suburb and non-global gateway favoring trends which will impact where and how office workers live, work, commute, and shop.

A 'shock absorber' for office, in general, is in-place leasing. The national vacancy rate when the pandemic hit in March was 9.9%, well below the 10-year average of 11.2%. As long as the tenants obligated on those

[1] CBRE, 2020 Global Occupier Sentiment Survey, The Future of the Office.


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leases remain financially viable and continue to pay rent, whether or not they occupy their space, the landlords of those buildings will have steady cash flow. The rubber will meet the road as leases mature and the tenants subject to those leases make decisions about how much space they need and where that space will be. The typical suburban office lease is 5 to 7 years, meaning 15% to 20% of the rent roll expires every year. CBD office leases are generally 7 to 10 years, resulting in 10% to 15% of 'roll' every year.

## Changing work trends

**What do you make of the trend of flexibility in allowing a portion of the workforce to work from home?**

The forced work-from-home experiment for office workers has worked quite well. We believe that remote work, along with shift-working, will have some durability. In a June 2020 occupier-sentiment study conducted by CBRE,[1] 70% of all respondents indicated that some portion of their workforce will be allowed to work from home permanently, while 61% of respondents indicated that all of their employees will be allowed to work remotely at least part-time. Companies and their employees are going to be finding their right balance to remain productive and effective.

Companies will have to reimagine how their office space is laid-out and utilized over the coming quarters and years. For businesses that value company culture and thrive on creativity and innovation to design, produce, and deliver best-in-class products and services, in-office collaboration is still the best and most efficient way to achieve that. Having said that, we

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believe that the levels of positive absorption that office markets enjoyed post-GFC will not be repeated during the next economic expansion.

**De-densification was already happening even before the pandemic hit. What has Covid-19 shown us about the importance of the office?**
Since the mid-1980s, the average space per person has dropped from about 250 sf to approximately 190 sf; a 24% decrease. This trend allowed companies to grow without leasing more space.

In the post-Covid-19 world, office space is going to de-densify. The de-densification will be necessary to enhance employees’ safety and health, and to make them *feel* safe and secure while in the office. Even after there’s a widely available and reliable vaccine, most office workers will want more space and distance between themselves and their colleagues.

Effective mentoring, on-boarding, and collaboration cannot be done remotely. Serendipitous meetings that lead to creative breakthroughs, enhance camaraderie, and promote innovation happen in the hallway, kitchen, and around the office lunch table; those are impossible in a remote-working construct.

**This is an opportunity for firms to reassess what they need and what they want as they look forward. Who are the winners and who are the losers?**

The thesis for trophy high-rise office properties in CBDs served by mass transit that has captivated most large institutional investors the past 20 years is going to be tested. Metropolitan areas enjoyed a long run of urbanization as millennials and others flocked to the urban cores to avail themselves of employment opportunities, cultural offerings, and entertainment. Many companies relocated to, or grew their footprints in, CBDs in order to tap into the deep pool of highly educated and talented employees residing there. The pandemic has upended that trend and the consequent sheltering-in-place has dimmed the allure of the city center for many.

Moreover, major cities are facing political and social challenges linked to recent unrest. Fairly or unfairly, urban dwellers are feeling less safe in many CBDs. In addition, those cities are confronting massive fiscal problems as a result of the economic downturn. The only way for them to plug their budget gaps is to increase taxes and/or decrease services, at a time they can least afford to do either.

Employers and workers are going to need a high level of certainty that the pandemic is over before we’ll see people congregating in crowded offices in large numbers. In the meantime, people and businesses may decide to move outside of the urban core where they feel safer and fiscal health is the norm. After the economy turns around, we expect that CBD office demand will be muted for the next cycle.

Suburban properties that are conveniently located, boast ample parking, and are easy to navigate will gain at the expense of CBD competitors. Interestingly, even before the pandemic there were some nascent trends pointing toward a ‘return to the suburbs.’ That shift will accelerate over the next few years.

## Valuing the office

**What do you see for office valuations?**
It depends. Some markets will suffer growing vacancy while others will skate by relatively unscathed. Markets with the most pronounced supply/demand imbalances will see the largest decreases in rents and biggest diminution in values. It’s impossible to know which markets will fare best because it all depends on the economic drivers in individual metros and the depth and duration of the contraction.

It’s imprudent to try to predict where values are going, but there are some important considerations. Because transaction volume has fallen precipitously since March, appraisers have very few comps to consider. Instead, they’re leaning heavily on discounted cash flow (DCF) models to discern values. In Q2, appraisers of office properties generally lowered rental growth rates, increased vacancy and credit loss factors, and lengthened lease-up/re-leasing periods. Those adjustments drove office property values down by approximately 2% to 5% from Q1 to Q2. Appraisers generally did not lower market rents or tack-on concessions, or adjust residual cap or discount rates. If market fundamentals weaken further, appraisers will further adjust leasing market assumptions which will, in the absence of countervailing changes to cap and discount rates, put further downward pressure on values.

During past recessions, increased uncertainty dictated a need for higher returns for investors. That would generally mean an increase in both residual cap rates and DCF discount rates. The downward move in 10-year Treasuries since the beginning of 2020 from about 2% to 0.6% widened the spread for investors by about 140 basis points. This 'extra cushion' seems to be adequate compensation in the eyes of the appraisal community. As long as that relationship holds up, we do not expect material adjustments to either cap or discount rates. Any changes to office values will be the result of leasing market assumption changes dictated by supply/demand fundamentals.

For context, during the GFC, office property valuations declined by 30% or more in some cases because the appraisers made material adjustments to both leasing and capital market assumptions. This 'turbo-charged' the negative impact on values. We do not anticipate the same thing happening this time around.

**There is a lot of dry powder. If office values are not coming down, is there a buying opportunity? Is there a play for distressed assets?**

We do not see any distress out there right now. The recession might be lengthy, but there is so much capital eager to get into any kind of real estate. This will dampen buying opportunities. We have seen some good deals, but we have not seen anything that we would characterize as a great deal. I think this will continue to be the case. Since there is so much uncertainty, we are going to guard our liquidity very carefully. We want to make sure we've got plenty to last through the duration of this downturn and then have enough to make some attractive buys once the worst of the storm passes and the view ahead is a little clearer. We don't know whether that will be 6 months or 16 months from now, but for the time being we'll remain patient and cautious.

For the past several years high quality suburban office properties traded in the 7% to 8% capitalization rate range, at substantial discounts to replacement cost, while premium CBD office buildings were transacting at 4% to 5% cap rates, at material premiums to replacement cost. For us, that 300 to 400 basis point arbitrage between the two alternatives dramatically favored the suburban office investment play. In light of the pandemic and the knock-on effects on office dynamics, we feel even stronger about that argument.

Over the past five years Bailard has purchased nine offices with a total aggregate square footage of 1.5 msf. All nine properties are located in suburban nodes around major metropolitan areas like Los Angeles, Denver, Chicago, Minneapolis, Columbus, and Washington, DC. Our average basis in those properties is less than $175 per sf, a substantial discount to replacement cost. This is an important metric for Bailard.

> "The recession might be lengthy, but there is so much capital eager to get into any kind of real estate. This will dampen buying opportunities."

## Looking ahead

**Do you see capex increasing now that offices have to be cleaner, safer and more secure?**

Definitely, and it will modestly dampen the value of office real estate. If those costs are increasing, landlords will try to pass those costs back to their tenants. But if tenants are forced to pay the higher operating costs, they will insist on lower rents. Alternatively, landlords can eat the additional costs which will simply lower the net operating income. Regardless, the net negative impact on office landlords will be about the same.

**Are we pricing risk into the market?**

In my mind, not in the equities markets. Admittedly, I'm not an expert on the public equities markets, but there's a disconnect between what's going on in the stock markets and what's going on in the real world. We believe that real estate is still relatively fairly priced because of where the 10-year Treasury sits. However, the ultimate arbiter of value is an asset's intrinsic value or replacement cost. Investors who, in the pre-Covid-19 cycle, bought assets at premiums to replacement cost are likely to experience material value declines. During recessions, values tend to regress back toward replacement cost (or below) as capital sorts out risk and reward in the effort to discover proper pricing. As the economy stumbles back to its feet, we expect a similar scenario to play out. ◆