the 9:05 An excerpt from Bailard's Quarterly Review of Economic and Market Developments Q2 2020

Office Property Dynamics in a Post-Pandemic World

Preston R. Sargent, Executive Vice President of Real Estate and
Ronald W. Kaiser, CRE, Director of Real Estate Research

When the novel coronavirus landed in the United States late in the first quarter of 2020, office space fundamentals were quite strong: vacancy was 9.9% and just shy of its 20-year low, net absorption was in a healthy balance with new supply, and rental rates were at all-time highs (~20% higher than the previous market peak in 2008 on the eve of the Great Financial Crisis).

Office property performance has historically been a good proxy for the state of the economy. If vacancy rates are low and leasing is strong, that's a sign that users of office space are optimistic about the economy and prospects for their businesses. The converse is also true. If businesses are not confident, they are not likely to take on new lease obligations and, in fact, may look for ways to lower costs by either shrinking their "footprint" through sub-leasing and/or moving to less expensive space.

> If businesses are not confident, they are not likely to take on new lease obligations.

As noted above, market conditions were solid at the end of the first quarter, and there was approximately 8 billion square feet of office space inventory across the country. CoStar, a nationally recognized real estate data aggregator and research firm, predicts that data for the second quarter will show 13.8 million square feet of ***negative*** absorption (meaning, demand is less than supply and vacancy increases). This will be the first time that absorption has been negative since the first quarter of 2010, which marked the end of a seven-quarter run where office properties suffered an aggregate total of ~55.5 million square feet of negative absorption.

Clearly, office tenants reacted very quickly to the nationwide shutdown triggered by the pandemic and the resulting economic contraction. At this point, it is impossible to predict how deep the current recession will be, how long it will last, and/or the contours of the recovery once the economy turns. One thing is for certain, the U.S. is not in a "normal" recession. Therefore, some of the rules of thumb that might help track the path of an expansion—and the positive impacts on the office market that have historically followed—are not likely to apply.

Since the imposition of nationwide "stay-at-home" orders this spring, the vast majority of office workers have been working remotely. Bailard is aware of a multitude of examples where multi-tenant office properties have remained 85% to 95% leased during the lockdown, but only 10% to 20% of the tenants' employees are present in the office. During this period, employees and employers alike (including Bailard) have been overwhelmingly surprised and pleased that technologies like Zoom, Teams, and WebEx have enabled everyone to work effectively and efficiently and stay connected and engaged (albeit remotely).

During the pendency of the stay-at-home orders we've all learned new behaviors. It is hardly possible to know which ones will become habitual, but it is safe to say that when a reliable vaccine is available and we're able to "get back to normal," that "normal" will have new rules and protocols for socializing, travel, entertainment, dining, and working.

What does this all mean for office space utilization, both near- and longer-term?

There are several shifts that point to a need for less office space in the future. It is possible that work-from-home and shift-working trends have become engrained, which would generate cost savings for companies embracing the trend and enhance employee productivity by avoiding commutes and in-office interruptions. Furthering this trend, there will likely be at least some near-term trauma and anxiety about potential for another outbreak.

On the other hand, there are powerful factors driving the need to maintain, or even expand, office space needs. Recruiting is enhanced when the interview process is in-person and new employees are on-boarded in a traditional manner with one-on-one mentoring. In-office and near-office amenities are also important to attract and retain talent. And company culture thrives on in-person interaction. Humans are social beings; team members working together in a collaborative (non-virtual) setting promotes productivity and innovation. Finally, the trend toward "de-densification" necessitates that companies increase their footprint, and provide more space for office workers.

It's futile to speculate which trends will have the stronger pull and, therefore, whether office space demand will suffer or grow because of the changes in behaviors forced on us by the pandemic. It is likely that many companies will embrace elements of both, i.e., let many/most employees work-from-home with greater frequency (perhaps permanently as in the case of Twitter, Shopify, Zillow, and Facebook), while at the same time reconfiguring offices to provide much more space to achieve sensible social distancing. For example, a "Fortune 100" tenant that Bailard spoke with plans to have 20% of its staff work-from-home on a rolling basis, but will expand individual workspaces from 225 square feet to 400 square feet… a net increase of 40% overall. It is important to remember that some companies can afford to "de-densify," while many others cannot.

Advocates for the view that the work-from-home paradigm thrust upon us by the pandemic will be short-lived are quick to point to some notable "telecommuting" failures, including Yahoo, IBM, AT&T, and Aetna. However, remember that these "experiments" were voluntary and attempted during times when it was not the norm. The mass work-from-home edict that was mandated by federal, state, and local authorities this year is entirely different. Nearly everyone was similarly situated and nobody was "left out." Moreover, the technology today is vastly superior and tech-savvy millennials are the largest cohort of office workers in the economy today. The potential "stickiness" of work-from-home strategies appears to be much greater today than in the recent past.

The potential "stickiness" of work-from-home strategies appears to be much greater today than in the recent past.

What Does it Mean for Office Property Investment?

With uncertainty swirling about the course of the pandemic from the timing of a reliable vaccine and the direction of the U.S. economy to the adoption of new socializing, shopping, and work protocols, it's impossible to accurately forecast office utilization dynamics. That said, the Bailard team believes there are a number of shifts ahead:

- Office buildings will experience negative absorption until the economy turns, causing vacancies to increase and rental rates to go down.
- Once an economic expansion resumes, there will be positive net demand for office space but at a lower volume. Even if the work-from-home phenomenon causes a 25% decline in leasing volume, as long as developers modulate their deliveries, office fundamentals can be in good balance.
- During the recession, office buildings in dense urban areas will, on a relative basis, suffer greater

loss of occupancy and diminution of rents than suburban properties.

- Many companies with office footprints exclusively in central business districts (CBD) will embrace a "hub and spoke" model whereby they retain a significant presence in the urban core but add a suburban location(s) to accommodate employee preferences.
- The multi-decade trend toward office densification (from a nationwide average of ~250 square feet to ~190 square feet per employee) will reverse, as companies accommodate the needs of office workers for greater distancing.
- Operating costs for office buildings, both urban and suburban, will increase as a result of additional cleaning of common areas and tenant suites, higher utility costs driven by more air changes and higher filtration requirements, and increased elevator trips due to fewer occupants to meet social distancing requirements.
- Co-working providers that require maximum densification to be profitable (e.g., WeWork) will either have to adapt their business model or they will fail.
- Mass transit systems in major urban markets will suffer huge losses in ridership as people retreat to their automobiles… making some CBDs less accessible.

The path forward will become clearer as the U.S. economy regains its footing after a COVID-19 vaccine is developed and deployed and we all attempt a return to more normal times. From an investment strategy standpoint, the Bailard real estate team feels it prudent to underweight the office property type. The trend of recent years toward clustering downtown, relying on public transit, and enjoying the exciting lifestyle offered by the big city is being severely challenged by the pandemic. Living, socializing, recreating, and working in densely-populated urban cores has had immense appeal for the past 15 to 20 years for both millennials coming of age and entering the workforce and also baby boomers downsizing from large suburban homes and returning to culture-rich urban centers. However, at this moment and for the foreseeable future, working in a low-rise building in a convenient and amply-parked easily accessible suburban location seems to offer greater safety and flexibility.

ABOUT *THE 9:05*

Since 1978, we've held a weekly company-wide meeting during which we talk about the prior week's activities and those anticipated in the week to come. We refer to this meeting, which begins just after nine each Monday morning, as "the 9:05." Just as the 9:05 meeting enables us to share our knowledge and insights with each other, this newsletter provides us with a valuable means of communicating with our clients. Hence its title: *the 9:05*.

the 9:05 is published four times a year by Bailard, Inc., 950 Tower Lane, Suite 1900, Foster City, California 94404-2131. (650) 571-5800. www.bailard.com. Publication dates vary depending upon the availability of critical data, but usually fall in the first month of each new quarter.

DISCLOSURES

the 9:05 is produced by the Asset Management Group of Bailard, Inc. The information in this publication is based primarily on data available as of June 30, 2020 and has been obtained from sources believed to be reliable, but its accuracy, completeness, and interpretation are not guaranteed. We do not think it should necessarily be relied on as a sole source of information and opinion.

This publication has been distributed for informational purposes only and is not a recommendation of, or an offer to sell or solicitation of an offer to buy any particular security, strategy, or investment product. It does not take into account the particular investment objectives, financial situations, or needs of individual clients. Any references to specific securities are included solely as general market commentary and were selected based on criteria unrelated to Bailard's portfolio recommendations or the past performance of any security held in any Bailard account. All investments have risks, including the risks that they can lose money and that the market value will fluctuate as the stock and bond markets fluctuate. Asset class specific risks include but are not limited to: 1) interest rate, credit, and liquidity risks (bonds); 2) style, size, and sector risks (U.S. stocks); 3) increased risk relative to U.S. stocks due to economic or political instability, differences in accounting principles, and fluctuating exchange rates – with heightened risk for emerging markets and even higher risks for frontier markets (international stocks); and 4) fluctuations in supply and demand, inexact valuations, and illiquidity (real estate). The volatility of real estate may be understated due to inexact and infrequent valuations. Real estate has significant risks and is not suitable for all investors. There is no guarantee that any investment strategy will achieve its objectives. Charts and performance information portrayed in this newsletter are not indicative of the past or future performance of any Bailard product, strategy, or account unless otherwise noted. Market index performance is presented on a total return basis (assuming reinvestment of dividends) unless otherwise noted. **Past performance is no guarantee of future results. All investments have the risk of loss.** This publication contains the current opinions of the authors and such opinions are subject to change without notice. Bailard cannot provide investment advice in any jurisdiction where it is prohibited from doing so.