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Office Sector Investment in a Pandemic Recession

BY **CHRISTOPHER C. RISING,** CO-FOUNDER & CEO OF RISING REALTY PARTNERS

OVERVIEW

> "So if our employees are in a role and situation that enables them to work from home and they want to continue to do so forever, we will make that happen."
>
> *- Jack Dorsey, CEO of Twitter (and Square), May 12, 2020*

Dorsey's statement sent office sector investors into a panic. One email at a San Francisco–based software company with fewer than 5,000 employees globally has convinced REIT analysts and CIOs that investment in core, core-plus, value-add, and opportunity office assets will no longer satisfy asset allocation strategies and may produce the biggest losses of the post-COVID-19 world. Whether anyone bothered to read the next sentence in the email or thought about the self-interest of a CEO trying to attract computer-engineering talent seems to be totally irrelevant.

The fact that Dorsey changed Twitter's corporate policy while the vast majority of people are locked down and forced to work from home to avoid a contagious and potentially deadly disease apparently meant that the office sector died.

For a sector that makes up more than 4.2 billion square feet across the United States, not including millions of square feet of federal and state office buildings, these long-term prognostications seem rather far-fetched. A recent survey during the pandemic commissioned by JLL backs this up.

The JLL survey found that 58% of office workers missed the office, with younger cohorts—ages 35 and under—showing an even stronger desire to return (65%). Human interaction and socializing with colleagues were the most missed elements of the office (44%), followed by collective face-to-face work (29%), according to the survey.

In other words, months of working from home has solidified a tried-and-true belief that Americans like working together in an office environment.

While there seems to be a hybrid model between office and remote work emerging, what is perfectly clear is that cloud-based software implemented at scale has allowed America's office workers to be truly mobile. No longer is office work bound to a desk to access legal documents or construction drawings. Today, a traditional office worker can be as efficient responding to email at 2 a.m. as they can be in reviewing financial analysis at a weekly, in-person 11 a.m. meeting.

For traditional office work, we have transitioned to a mobile workforce. However, as human beings, we still desire social interaction and the power of in-person collaboration. Most people benefit from social ties and face-to-face social interaction, as researched in a Harvard study on social engagement and healthy aging. The study noted that social isolation reduces opportunities for brain stimulation and increases the risk of poor mental and physical well-being as one begins to age.

Team building also requires trust and confidence in others. No matter how loud the "Work from Home" evangelists may shout, we are still a society that learns, grows and is stimulated through direct interaction with people.

This person-to-person collaboration is good not only for business but, more importantly, for the soul.

In a joint study conducted by the University of Oregon and the University of Washington, it was found that the combination of employment loss and financial hardship leads to elevated anxiety and depressive symptoms. The study found that the degradation of one's mental health during economic recessions increases the risk of negative coping behaviors, such as alcohol and drug use, for up to four years post-recession. Individuals continue to experience higher rates of new symptoms, permanently impacting their livelihood as time goes on.

A serious analysis of the future of the office market in the United States requires an analysis of the four powerful forces that will dictate the office sector in our 21st-century economy:

1. **The COVID-19 Pandemic**
2. **The Pandemic Recession of 2020**
3. **The Ascent to Power of Gen Xers and Millennials**
4. **Cloud-Based, 21st-Century Jobs**

In the summer of 2020, we are still in the "basement" with the "tornado" overhead. Companies are managing their workforce via triage. While productivity may be high, fear of losing one's job is also at its highest levels since the global financial crisis (GFC).

We are also in a deep recession. The International Monetary Fund continues to project a significantly deeper economic downturn as of June 2020, with global gross domestic product (GDP) expected to shrink 4.9% in this year alone. The current recession is about 10% of global economic output when compared to the Great Depression of the 1930s, as reported by Bloomberg News.

According to a Deloitte Insights piece published June 15, 2020, the U.S. economy lost 20 million jobs in March and April and the devastation has been particularly harsh on sectors like arts, entertainment, and recreation services (down 55%) and accommodation and food services (down 47%). Deloitte predicts that the GDP will have fallen more than 17% over the first two quarters of 2020.

This Pandemic Recession of 2020 will produce many of the same results in the office sector that we saw during the GFC. Furthermore, we are experiencing a monumental change in leadership with the largest generation in the history of the United States retiring. New bosses from two different generations, Gen X and Millennial, are doing things differently and will continue to do so. Finally, we are in the midst of dramatic technological change—the rise of cloud-based work. The emergence of a truly mobile workforce, due to the proliferation of cloud-based software technologies, is changing company cultures and interactions.

For the office sector to come back, it must digest and work through the recession. But ultimately, office tenants will need to be wary of the cost of cutting leases today with the added expense on company culture. Office owners and tenants must meet the needs of a new generation of leadership that has and will continue to use new tools for a mobile workforce. Those property owners who can meet the technological needs of the new generation will win. The office sector is not going away. We will not be a society of Zoom-fueled, homebound workers. But when the pandemic ends, "work" will be different and typical work hours and expectations around "office face time" will change.

As Morgan Stanley CEO James Gorman said, **"Do I think everyone is going to be working from home? No. The mentoring, the connection, the team bonding, the brainstorming, the creativity that comes from being in groups of individuals, like-minded and not like-minded, that's how great organizations thrive. But can I see a future where part of every week, certainly part of every month, a lot of our employees will be at home? Absolutely."**

The Immediate Impact of the COVID-19 Pandemic

The United States is in the midst of a once-in-a-century pandemic, with total number of deaths, as of July 23, of more than 130,000 Americans. In contrast, the Spanish flu, which occurred between January 1918 and December 1920, infected an estimated 500 million people worldwide and killed about 675,000 people in the U.S., according to the CDC.

The economic impacts are profound. State and local governments have forcibly closed businesses, private and public buildings, facilities, and public parks and beaches. The result is the largest number of layoffs in the history of the United States, which at over 30 million, is the worst economic landscape the country has ever experienced. Real gross domestic product (GDP) decreased 5.0 percent in the first quarter of 2020, according to the "third" estimate released by the Bureau of Economic Analysis. The decline is the same as the "second" estimate released in May.

Yet there are many pundits who think the solution to massive economic upheaval is to work from home on an unsecured home Wi-Fi system. Certain pundits continue to make arguments for drastic changes in our work environment, yet at this time even schools from pre-kindergarten to colleges are closed for the foreseeable future, and families are still being told to stay at home, continue to wear a mask, and stay six feet apart.

Companies have come to terms with the fact that the home semi-office is good enough for now, but working from a kitchen table, hiding away in a closet to take a call, or having the kids interrupt an important Zoom meeting is unsustainable. Furthermore, there have been few studies on technological security risks and health risks for people working from home.

As more organizations turn to videoconferencing platforms such as Zoom, several incidents of "Zoombombings" or "Zoom raiding" have been reported during work meetings or online classes. Uninvited participants have displayed disturbing images and used racial epithets or profanity, among other forms of harassment, as reported by the *New York Times*. The USC Shoah Foundation has decried these incidents for targeting "spaces of learning and personal growth." For participants using such platforms to work or attend school, this adds a new stress that can fuel anxiety and create trauma, as virtual videoconferencing attempts to simulate social interaction.

Any CEO making a long-term decision about abandoning their office space for a work-from-home platform seems shortsighted at best. It makes sense that in a time of distress, people will do their best to keep working and push through. But it doesn't make sense to abandon capital investment and a proven work environment during a short-term duress as we collectively battle COVID-19.

The Analytics Behind the Pandemic Recession of 2020

The United States economy has entered a recession. In June, the Federal Reserve projected a particularly sharp economic hit in 2020, with officials expecting output to contract by 6.5% at the end of this year, compared to the final quarter of 2019. Further, the Federal Reserve stated it would leave interest rates at or near zero for the foreseeable future as the central bank projected high unemployment for several years and a long slog back from the pandemic-induced recession.

The office sector is particularly vulnerable to economic recession due to its reliance on job growth. In a recession, CFOs and CEOs look to cut costs and most companies have two levers they can pull: (1) cut their workforce; and (2) reduce their liabilities. After salaries, most businesses' largest liability is their commitment to real estate leases. It should not be a surprise that office vacancy will grow, rental rates will drop, and incentives for companies to lease space will increase. This has happened in each of the four previous office recessions I have experienced, and it will happen now. Perhaps the best one can do is look at the effects of the GFC on the office sector.

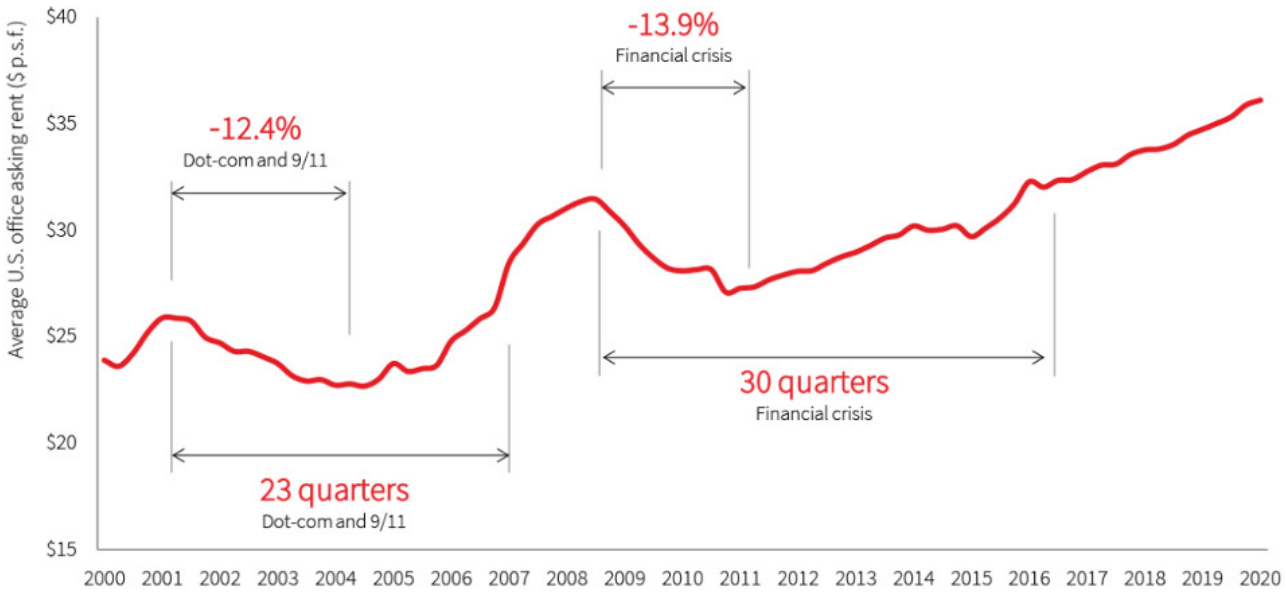
From December 2007 to December 2009, 2.5 million of 4 million total job losses were in the office-using sectors of information, finance, and professional and business services. As a result, the U.S. office vacancy rate soared to 18.7% by the second quarter of 2010. Yet the actual net absorption of negative 75 million square feet was only one-third of the potential decline indicated by the job losses, suggesting the presence of a substantial amount of shadow space—empty cubes, floors, or wings vacated due to layoffs but still counted as occupied. Had the job losses registered right away as negative absorption, the vacancy rate would have sailed above 22%.

From the peak in Q3 2007 (pricing = 100), the office property price index fell to 53 in Q2 2009, a 47% decline. Office pricing fully recovered to its peak (100) in Q4 2014, 5.25 years after the bottom, and 7.25 years after the prior peak. Pre-COVID-19, the office price index reached a high of 117 in February 2020, a 220% increase since the market bottom. Since then, the office price index has fallen 8%, to 107. It only took two quarters from the Q2 2009 trough for the pricing to increase more than 8% off the lows. By January 2020, office pricing had increased by 14%.

Cap rates hit a low of 4.7% in Q3 2007, widened to 8.8% at the trough in Q2 2009, and then compressed down to 4.9% in the middle of 2016. Cap rates slowly widened to 5.1% pre-COVID-19 and popped up to 5.4% over the past three months. As of June 2020, cap rates have only widened by 30 bps due to COVID-19, compared to a 410 bp increase attributable to the GFC.

From 2007 to 2009, 60 million square feet of new office was constructed per year. During the GFC, office construction slowed dramatically, such that new office construction deliveries hit only about 8 million square feet by 2012. Since 2016, new deliveries have averaged 55 million square feet per year, in line with long-term historic averages. What is perhaps most important to focus on is that the GFC presented 9 total quarters of negative absorption, with no individual quarters exceeding a 1% decrease in vacancy.

Since 2000, downturns have seen 13.2% average rent declines for office products with 6.6 years to return to pre-recession levels.



Source: JLL.

During the recovery, Class A CBD filled first in 2010 and 2011. Then Class A Suburban in 2011 through 2013. Class B space did not begin to fill until 2013, four years after the recovery started. While history doesn't repeat itself, it does rhyme. Since 2000, downturns have seen 13.2% average rent declines for office products with 6.6 years to return to pre-recession levels.

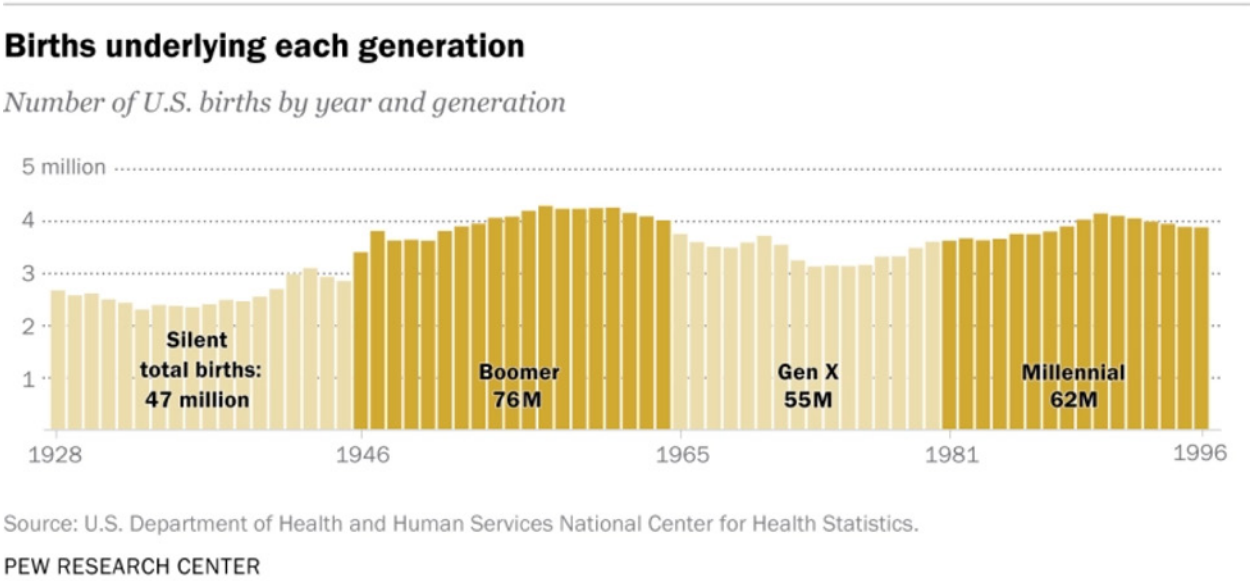
So what is the future of office as the result of the Pandemic Recession of 2020? Green Street Advisors offered this Sector Snapshot*:

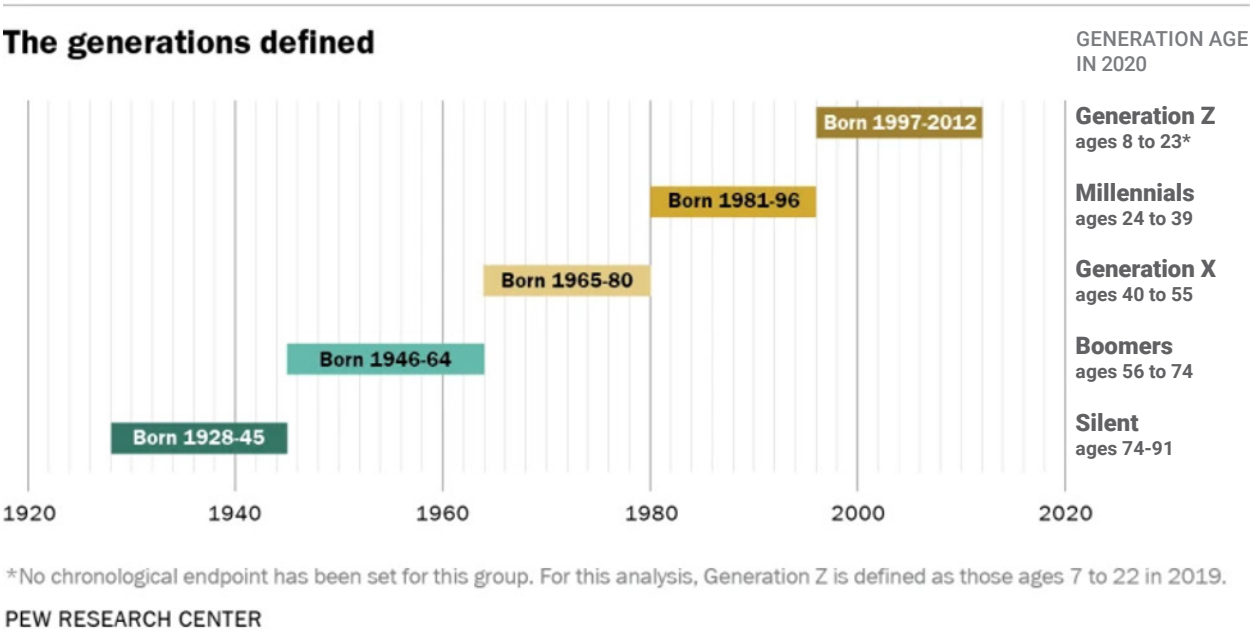
- Office-using jobs were not immune to recent job losses (-7% YoY decline in April nationally).
- Five-year rent growth forecast reduced to -1.7%/yr given larger expected rent declines in '20/'21.
- Non-gateway (NGW) markets to fare better than gateway (GW).
- Supply growth expectations have been cut modestly (-30 bps/annum to 1.1%/yr); fewer new starts expected.
- Transaction activity has slowed post-COVID-19, but failed trades and anecdotal evidence suggests values are down.
- Valuations for core, institutional quality office is down ~10% nationally from start of the year.
- Cap rates have climbed modestly; most of value reduction driven by reduced NOI forecasts.
- Debt spreads have come in, which should serve as a valuation support.
- Rent collections have been encouraging and have exceeded our initial expectations thus far.
- WFH ("work from home") likely to have an increasingly bigger and negative (albeit slow-moving) impact.
- Initial cursory analysis suggests the WFH impact could reduce longer-term office demand by 10-15%.

** Green Street Advisors Sector Snapshot: Office Published on June 5, 2020.*

The Ascent to Power of Gen X and Millennials

The United States is also in the middle of a tremendous generational change. Baby Boomers, the largest generation, are retiring and the resulting change in corporate leadership will impact the economy and the office sector.





In 2018, the average age of CEOs in the United States stood at 54.1 years, while the average age of CFOs was 48.9 years. Today, the demographics of the office user are changing dramatically. Baby Boomers (ages 56 to 74) represent about 71.6 million people in the U.S., followed by 65.2 million Gen Xers (ages 40 to 55) who now make up 38% of the workforce, Millennials (ages 24 to 39) representing 35% of the labor force, and Gen Z (ages 8 to 23) representing 5% of the labor force. Millennials have overtaken Baby Boomers as America's largest generation and are projected to peak in 2033 with 75 million people in the workforce. Our emerging generation of corporate leaders are the first to grow up with modern technology as part of their daily lives and have witnessed the disappearance of many jobs due to technological advancement and automation.

From the disappearance of law libraries to the growth of co-working and enterprise leasing, the office was already changing, and it will continue to change to suit the next generation of business leaders. For example, according to JLL, 70% of millennials prefer to work at a company with a strong sustainability agenda. Millennials' exposure to climate change is significantly greater and has caused greater weight to corporate sustainability through ESG. Interestingly, corporate sustainability has seen a transition during COVID-19, much of which has been the center of webinars during the pandemic. During the GFC, many people predicted that corporate sustainability was a dying "fad," but this was not the case as a group of 300 mutual funds that consider ESG factors when making investment decisions saw inflows of $21.4 billion in 2019 vs. $5.4 billion in 2018, an effective 296% increase.

The Cloud-Based Mobile Workforce

A cloud-based application is a software program where the "cloud-based" server, e.g., a server in a data center, works with local components for the user. More often these local components are smartphones, tablets, or laptop computers. The system requires remote servers for processing that are accessed through a Web browser with a continuous Internet connection. In the '90s and early 2000s, most larger companies were operating their own servers, usually within their corporate headquarters. After the terrorist attacks of September 11, 2001, some companies began to move their corporate servers to off-site locations. Cloud computing started to evolve during this time but the cloud we're familiar with today did not become a reality until 2009, when EUCALYPTUS (Elastic Utility Computing Architecture for Linking Your Programs to Useful Systems) was created to be used with Amazon Web Services and 2010 when OpenStack was created by Rackspace and NASA.

Over the last 10 years, companies have moved away from their own servers to cloud experiences operated by AWS, Azure (Microsoft) and Google Cloud (among many others). With the birth of the cloud experience, software companies, led most notably by Salesforce, offered corporations software as a service (SaaS) rather than software through CD-ROM. As smartphones and tablets have surpassed the desktops of old, companies have become truly paperless. Documents long held in metal file cabinets now reside in the cloud and are available with a swipe of the mouse. This dramatic change in the tools needed to produce "work" has also radically affected how office space is used.

Long gone are the days of a law firm having a physical law library or large consulting firm requiring a large word processing department. IBM, a multinational technology company, plans to reduce their office spaces by nearly half in all major cities in their India sector. This is not the first time IBM has restructured their physical office spaces, having embraced remote work for decades beginning in the 1980s when the company installed "remote terminals" in several employees' homes.

The effect of cloud computing on office space helped expand WeWork, a co-working company, as well as with the office "hoteling" arrangements made popular by the large international consulting firms and services firms. The concept was simple—your office is your laptop and you can work from anywhere. Dedicated offices were no longer required and without the need for file storage or physical books and documents, offices became denser with people.

Furthermore, SaaS companies began to proliferate. Every industry was under attack by a venture-funded computer scientist or entrepreneur who could replace the physical world for work with software in the cloud. As the cloud grew in favor, new business terms began to appear: "customer churn rate," "freemium," "PropTech," "product-led-go-to-market Strategy," and "visitor-to-signup rate." Companies like Box and Dropbox moved to the forefront of cloud-based storage. The big tech companies like Microsoft, Google, and Apple followed suit with their digital storage options.

Many desktop-based companies offered new cloud-based products. Companies like Adobe brought their Acrobat, Illustrator and Photoshop to cloud—no longer were customers bound to an extra hard drive or large desktop system. Microsoft, Google, and Salesforce brought shared documents, spreadsheets, and slide decks to the cloud so that teams could collaborate in real time in the cloud. Project management software like Asana, Basecamp, and Trello became standard tools in an office environment. Then came the explosion of communication software to "kill email": Slack and other competitors. The fact is that over the last 10 years, tools have been created such that one needs only a smartphone to conduct business across the world.

If C-suite executives were truly honest, most have operated as a mobile workforce over the last few years—no longer spending their entire workdays at a desk on the executive floor of a major high-rise. C-suite executives have been traveling across the country and around the world, connected in the cloud, running their businesses from the road. It was not until the pandemic that the C-suite truly recognized that other than truly essential employees, their entire workforce could be mobile if and when needed. These now mobile employees are using the same tools the C-suite mastered over the last few years.

Going Forward

The question really is: Has the pandemic-induced recession of 2020, combined with a new generation of leadership and tools, killed the need for offices in the corporate world? While it is important to acknowledge that long-term predictions must give way to short-term solutions, it is unrealistic to think that the culture that built the most valuable companies in the world will now pivot to a workforce known only through cloud-based software and video conferencing.

1. Recessions hurt the occupancy, rental rates, and economics of the office sector. It is obvious that the office sector will suffer a pullback in investment in both the public and private markets. This has happened in each recession since the 1980s, and it will happen again. Occupancy levels will drop, rental rates will come down, and owners will offer tenants more incentives to lease space. We expect the value of office buildings to drop 5% to 20%, depending on the quality of the rent roll, the location of the asset, and the modernization of the building's infrastructure.

2. The infrastructure of an office building continues to evolve with broadband, health and wellness, and functionality determining winners and losers. Office tenants will demand more from their office than ever before. Technology in terms of increased broadband speed and encrypted Wi-Fi will be required. Offices that do not track the quality of natural light, air, and water will be passed over for those that do. Finally, the traditional lease structure based on a defined tenant improvement allowance will be put to the test. As companies demand more flexibility, owners will be less likely to fund large tenant-improvement allowances. Rather, more and more office buildings will be forced to provide a higher quality of service with less specialized space to meet the lease terms required by a mobile workforce.

3. The work from home "experiment" is not a new trend developed by millennials and is not the future of corporate America. While the hardware and software of 2020 are certainly far more advanced than the tech of the 1980s, "experts" have proclaimed the death of the office for almost 50 years. As long ago as 1985, the mainstream media was using phrases like "the growing telecommuting movement." Peter Drucker, the management guru, declared in 1989 that "commuting to office work is obsolete." The arguments for a permanent workforce at home have not changed much over the years. The long list of Fortune 500 companies who have moved toward the work-from-home culture is filled with much bigger names than the tech/computer scientist-focused companies like Quora, Shopify, and Slack. Prior to COVID-19, companies like Aetna, Best Buy, Bank of America, Yahoo, AT&T, and Reddit all tried and eventually abandoned the permanent work-from-home corporate culture. While working from home might seem like an easier alternative for several businesses and companies, the added stress for overworked employees is often not taken into consideration. In certain cases, employees are adding up to three more work hours to their day by working at home, as reported by Bloomberg News. John Tamny in Real Clear Markets recently wrote: "Much as the division of labor breeds specialization that results in exponentially more production than the kind that occurs among workers toiling all alone, so does division of thought promote exponentially greater innovation. Essential is that the thinkers cross paths in random ways that can't be randomized on Zoom."

4. The pandemic has forced businesses to disregard the security risks, but that will not last. Corporate America is in triage. For the first time in the history of the United States, the government has forced businesses to close. CEOs have been forced to "the next best thing," which has been to have endless Zoom meetings from the "safety and security" of their home Wi-Fi router. Given the options, the cybersecurity risk seems worth it for a scared workforce just relieved to have a paycheck.

A headline from the *New York Times* last week read: "Russian Criminal Group Finds New Target: Americans Working at Home." The article goes on to state: "In an urgent warning issued Thursday night, [Symantec] reported that Russian hackers had exploited the sudden change in American work habits to inject code into corporate networks with a speed and breadth not previously witnessed." As "Zoom-bombings" became more frequent, even the FBI became involved to investigate the weaponization of online videoconferencing websites. As time passes and these cyberattacks continue to threaten companies, there will have to be a hard look at the price of working from home.

Is it realistic to provide employees with additional pay to outfit their rented apartments, all while they could leave for a new job the next day? What is the cost of the vulnerability of work from home? Many companies may not get two chances to figure that out. The sophistication of these attacks is unprecedented. While many of America's corporations believe a virtual private network (VPN) will provide a company the same protection as if employees were in the office, the reality is much different. As the *New York Times* article highlighted: "'These attacks do not try to get into the VPN,' [Symantec's technical director Eric] Chien said. 'They just use it to identify who the user works for.' Then the systems wait for the worker to go to a public or commercial website and use that moment to infect their computer. Once the machine is reconnected to the corporate network, the code is deployed, in hopes of gaining access to corporate systems."

5. Businesses are as successful as their culture will allow them to be. It has been said that company culture can be defined as the "personality" of an organization. While culture certainly relies on the leadership of executives and employees, it absolutely relies on opportunities for trust and empathy to develop among people. The number of business books that discuss the importance of culture to a company's success is almost limitless. All revolve around basic social interaction. The common themes are always around community, trust, and caring. In his book Winning, Jack Welch, chairman and CEO of General Electric (GE) between 1981 and 2001, unpacked how those who work in offices and have a great work-life balance do so due to their ability to cultivate relationships, budget time, and set boundaries. This minimizes crises that spill over from work to home or the other way around.

Employees only working from home experience marginalization and usually have less loyalty to the companies they represent, as reported by the *New York Times*. Remote employees also suffer from reduced innovative abilities and seem less creative and happy, the same article reported. An example is Yahoo employees, who had a huge change of environment in 2013 when Marissa Mayer, Yahoo's chief executive at the time, called all employees back into the office, noting the best decisions come from social interaction at work, whether it be in cafeterias or hallways of offices. Even IBM, who implemented "work from home" back in the 1980s called thousands of its employees back into physical offices in 2017, after revenue slumping.

The short-term picture for office real estate—over the next several months—is a hard pill to swallow and will likely be worse than the GFC. We expect to see some major tech firms give back large blocks of space and test the limits of work from home. We also expect white-collar service firms to block off space in the New York, Chicago, Denver, Dallas, Houston, San Francisco, and Los Angeles commercial real estate markets. Similarly, we anticipate a significant number of foreclosures on hotel and office assets in the first quarter of 2021. However, we also believe the bounce back will be faster than the GFC. There is still a tremendous amount of money in the system and it will continue coming in as the election approaches.

Ultimately, we remain optimistic about the long-term health of the office sector. Central business district offices will not be mothballed and the role of the office will continue to evolve to meet the needs of business. We believe that many office properties will be mispriced and undervalued in the near-term, making the rest of 2020 through 2021 a great time for opportunistic investments. There will be opportunities to upgrade well-located but dated buildings with impact-driven improvements focused on tenant priorities such as health and wellness. The reality is that real estate will prove once again that "trees don't grow to the sky" and as my father Nelson Rising often says, "Real estate is a cyclical business; if you think it is no longer that way, it means it's about to turn." As long as companies value culture, there will be a need for office space.