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Real Estate: Evaluating the Office Landscape

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The COVID-19 pandemic drastically shifted the way in which many businesses operate and view remote work schedules. Many companies that used to require employees to be in the office five days a week have adopted some variation of hybrid work, meaning some days in the office and some days working remotely. Three years after the start of the pandemic, it appears that a hybrid working environment is becoming the new norm for many employers.

As part of the shift to hybrid work schedules, many companies are reevaluating their current office space needs. Perhaps unsurprisingly, many have begun or are planning to downsize their office footprint over the next few years. This means that office, one of the four main property types found in institutional real estate portfolios, is likely to experience a significant structural change. This may translate into a decline in future office construction projects, reductions in overall office utilization, as well as redevelopments and conversions of office spaces into other property types.

Remote working trends

Hybrid work schedules are the new status quo. Across all types of office-using occupations, 58% of US workers currently have the option to work from home at least one day a week.[1] Employees who are offered the ability to work remotely average three days per week from home.[1] While popular during the pandemic, fully remote work schedules have started to become more uncommon, and fewer employers are offering fully remote positions to employees. Fully remote job postings on LinkedIn dropped from a peak of 20% in February 2022 down to 14% in September 2022,[2] and only 8% of employers intend to have fully remote or virtual-first hiring going forward.[3] Hybrid schedules can vary by company, team, and industry (as shown in Figure 1).

[1] Source: McKinsey's American Opportunity Survey, June 2022.

[2] Source: Bloomberg, "More People Want to Work from Home but Remote Job Postings Are Declining," October 2022.

[3] Source: CBRE, "Spring 2022 US Office Occupier Sentiment Survey," April 2022.

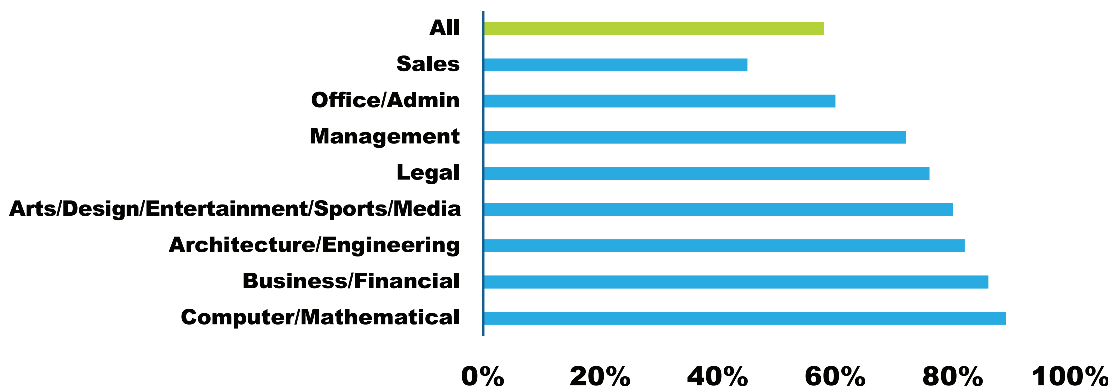

FIGURE 1
Percentage of Jobs with Option to Work At Least One Day Remotely by Occupation

Source: McKinsey's American Opportunity Survey, June 2022.

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In some form or another, hybrid work is expected to continue as the new normal, which has led some companies to rethink their office space requirements, given the high fixed costs of office space for many businesses. There are some estimates that the shift to a hybrid work model could result in a reduction of office space demand between 9% and 15% and an excess vacancy of more than 5% above the traditional natural vacancy level, which historically has averaged 12%.[4,5]

[4] Source: Commonwealth Partners FSP AIP Presentation 2023-24. "CBRE has estimated that hybrid work could result in a reduction of office space between 9% - 15%. C&W projects that hybrid work's impact on office demand will result in an "excess" vacancy of 5.7% above the natural vacancy level."

[5] Source: NCREIF Trends Report, as of Q1 2023. Average is for the period Q1 1988 to Q1 2023..

How does remote work affect the commercial office market?

Lower office utilization

Office utilization dropped to unprecedented levels during the COVID-19 pandemic. Since then, utilization has slowly increased, however it remains well below pre-pandemic levels. Figure 2 illustrates office utilization rates as a percent of pre-COVID utilization in the top 10 US cities. After reaching a low of 15%, office utilization has since rebounded to 50% of pre-COVID utilization, measured using employee keycard swipes into office buildings.[6]

[6] Source: Bloomberg, weekly data as of July 11, 2023. Index used: Kastle 10 US Cities Barometer.

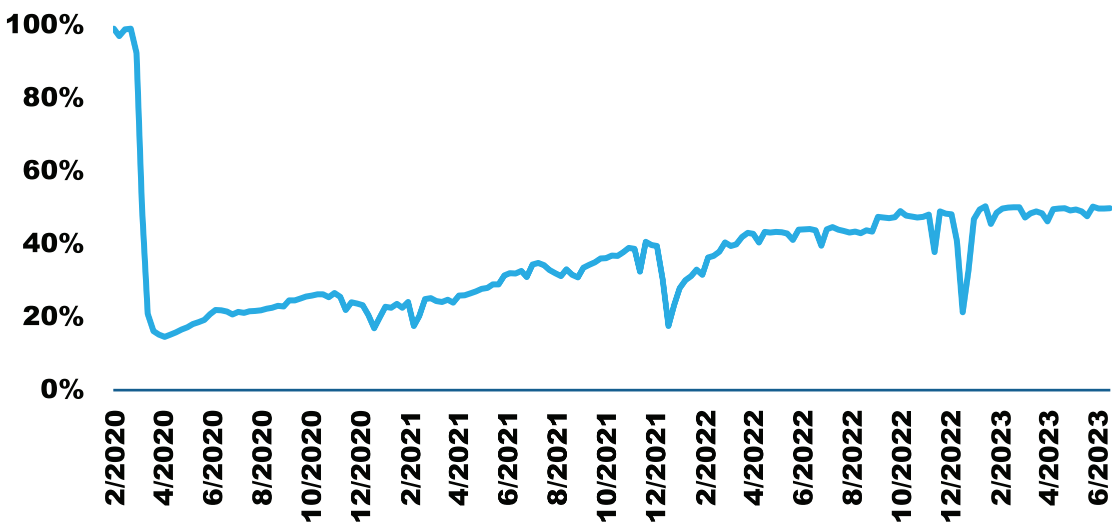

FIGURE 2

US Top 10 Cities Office Utilization (As a percent of pre-COVID baseline)

Source: Bloomberg, weekly data as of July 11, 2023. Index used: Kastle 10 US Cities Barometer.

The United States as a whole lags the rest of the world in returning to the office. Figure 3 lists each region's current office utilization rate as a percentage of pre-pandemic utilization. Asia leads the return-to-office trend with occupancy nearly back to pre-pandemic levels, while Europe closely trails with approximately three quarters of pre-pandemic utilization. The US has been the slowest to rebound, with utilization rates only about half of what they were pre-pandemic.

Region	Return-to-Office Rate
Asia	80% - 110%
Europe	70% - 90%
United States	40% - 60%

FIGURE 3

Global Office Occupancy as a Percentage of Pre-COVID Utilization by Region

Source: Wall Street Journal, "As Americans Work from Home, Europeans and Asians Head Back to the Office," February 2023.

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Softened leasing trends

Decreased office utilization rates will naturally prompt many companies to reevaluate their current and future office leases. Assuming hybrid work continues to be the new normal, employers may be enticed to seek smaller office footprints and/or offices in lower cost locations. Figure 4 shows how office vacancies are elevated in every major US city. Silicon Valley and San Francisco, historically two of the most expensive office markets, show large increases in vacancies from pre-pandemic to Q1 2023.

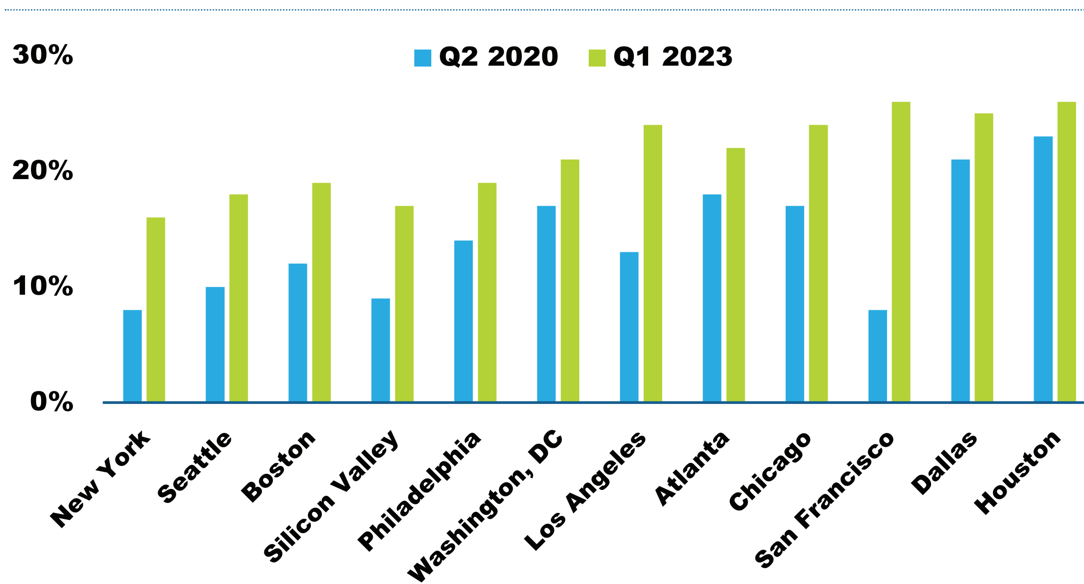

FIGURE 4

Office Vacancies in Major Cities Pre-Pandemic versus Post-Pandemic

Source: JLL's Q1 2023 Office Outlook and Q2 2020 Office Outlook.

Overall, there has been a 34% decrease in leasing activity from Q4 2019 to Q1 2023.[7] While activity has partially recovered from the trough in Q2 2020, it is still well below pre-pandemic levels, as shown in Figure 5.

[7] Source: JLL's Q1 2023 Office Outlook.

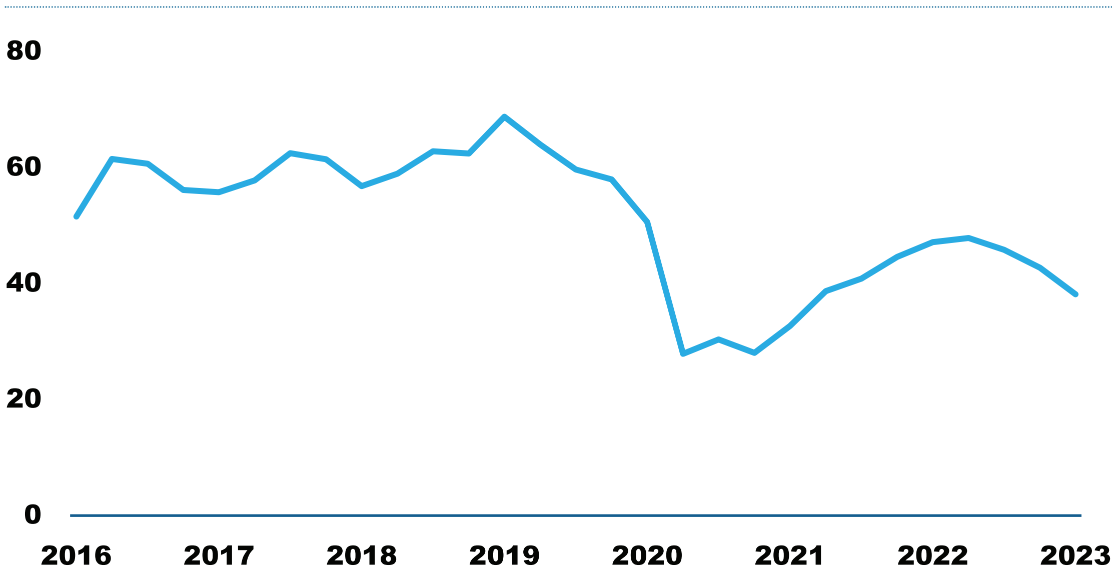

FIGURE 5

Office Leasing Activity (in millions of square feet)

Source: JLL's Q1 2023 Office Outlook.

The office market has not experienced the full effect of the evolving hybrid work environment, as many leases that were signed prior to the pandemic will not expire for another 3-4 years (pre-pandemic office leases generally averaged seven years).[8]

[8] Source: JLL, "Office leases are getting shorter," July 2020.

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Companies that want to downsize or find a new location have the option to wait until their current lease expires, pay an early termination fee, or sublease to another user.[9] Of the active office leases in the US, only 36% expired between 2020 and 2022, and many of those tenants signed shorter-term lease extensions with the plan to reevaluate their office space needs as in-office expectations normalized. It is estimated that 41% of leases (as measured by active square footage) are set to expire between 2023 and 2025,[10] with most of these companies evaluating their future office needs in this hybrid work environment for the first time.

[9] As of Q1 2023, sublease office space was at a record high, roughly doubling from the start of the pandemic. This could present further challenges for office landlords. Source: CBRE Econometric Advisors, Q1 2023.

[10] Source: Gupta et. al., "Work from Home and the Office Real Estate Apocalypse," June 2022.

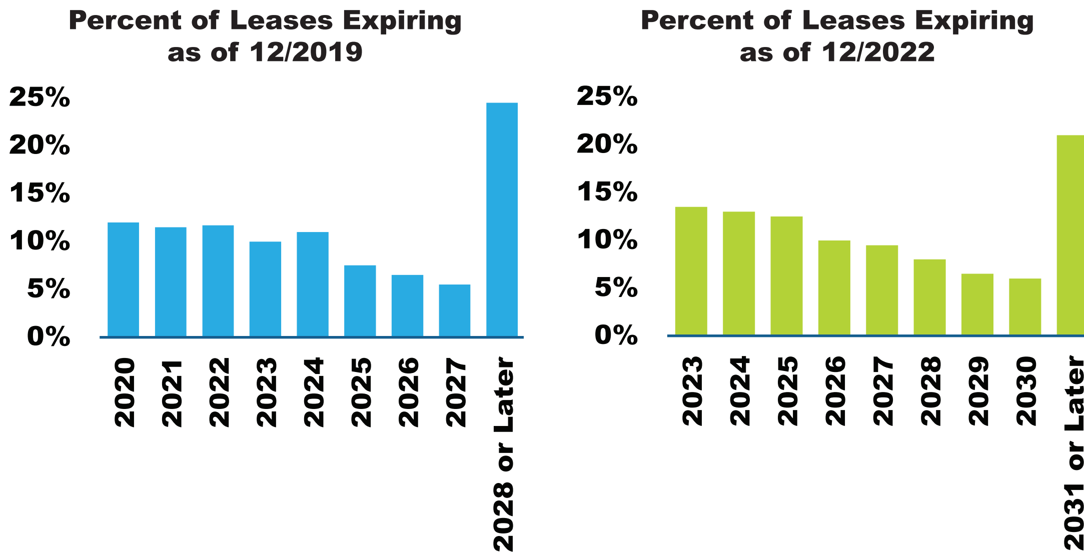

FIGURE 6
Staggered Lease Expiration Estimates

Source: Gupta et. al., "Work from Home and the Office Real Estate Apocalypse," June 2022.

As leasing demand weakens, landlords have needed to become more competitive for new leases, usually in the form of more expensive concessions and tenant improvement packages, particularly if the office is an older building. This implies lower bargaining power for landlords as they seek to backfill vacant space.

Weak absorption

Absorption in real estate signals trends in tenant demand relative to the available supply. Net absorption trends indicate the amount of space that was leased and/or vacated over a period of time, while accounting for the construction of new space and/or the removal of existing space. Positive absorption occurs when more space is leased (or, "absorbed") over a period of time. Negative absorption is the opposite, where more space was vacated than leased over that period.

Figure 7 shows that net absorption declined significantly during the pandemic, experienced a brief uptick during the second half of 2021, and reverted to being barely positive over the first three quarters of 2022. The pre-COVID-19 (Q1 2016 to Q4 2019) average quarterly absorption rate was 12.7 million square feet while the average since Q1 2020 has been -8.0 million square feet. In total, there has been 87.8 million square feet of negative absorption since Q1 2020, meaning significantly more office space has been vacated than leased post-pandemic.[11]

[11] Source: CBRE's US Real Estate Market Outlook 2023, as of Q3 2022. Total represents the sum of Q1 2020 to Q3 2022.

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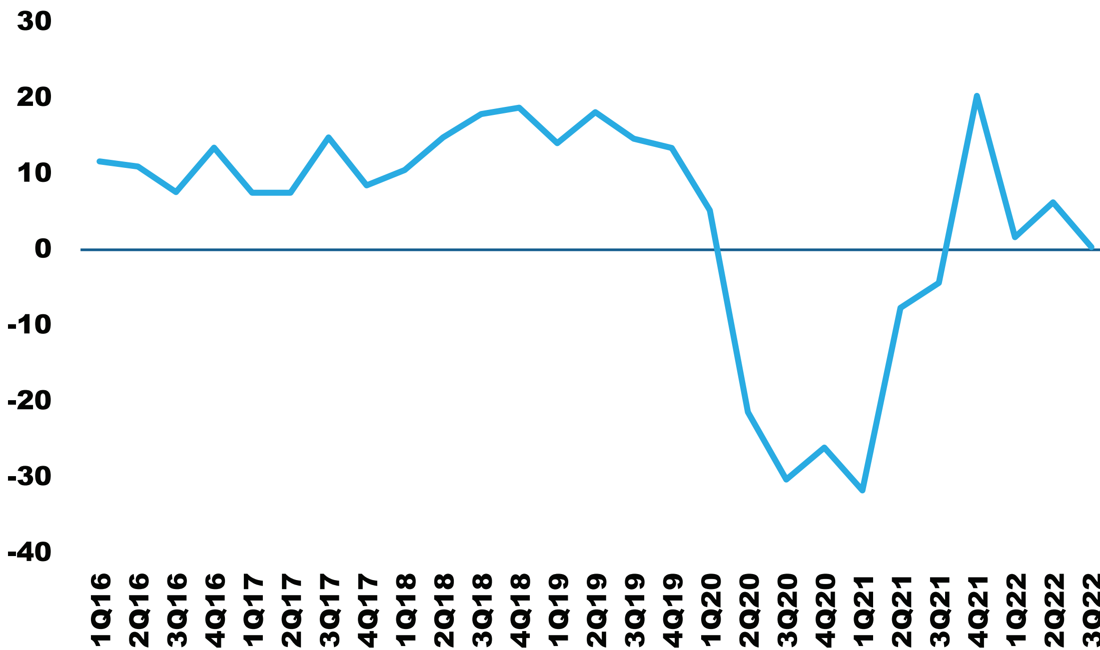

FIGURE 7

Net Office Absorption (in millions of square feet)

Source: CBRE's US Real Estate Market Outlook 2023, as of Q3 2022.

While overall net absorption has been negative since March 2020, there has been a bifurcation between older and newer buildings. Figure 8 shows that newer office buildings, specifically those built in 2015 or later, show positive absorption rates since the pandemic began. This may indicate a "flight to quality" as the newest properties are receiving the highest level of demand. Further fueling this positive absorption for newer buildings is the lack of supply for offices built after 2010, which currently represents approximately 5% of total office stock in the major metro markets, as shown in Figure 9.[12]

[12] Source: Moody's Analytics CRE, as of Q4 2022.

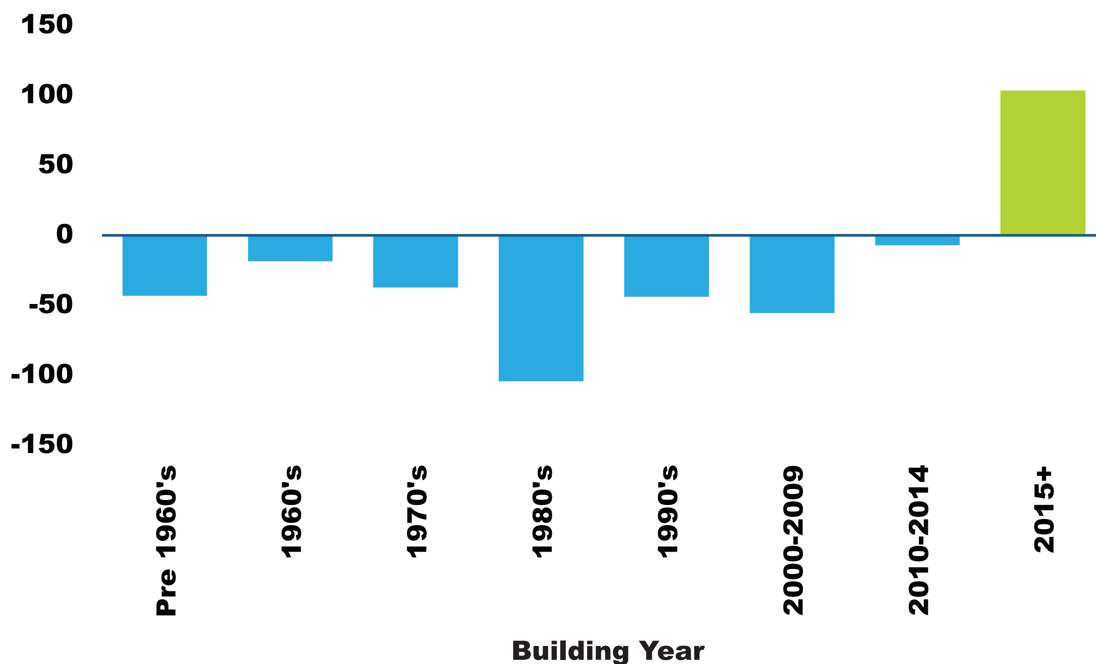

FIGURE 8

Absorption Rate Since March 2020 (in millions of square feet)

Source: JLL's Q1 2023 Office Outlook.

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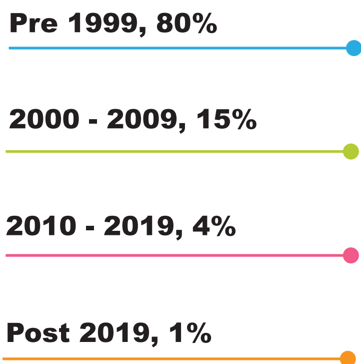

FIGURE 9
Building Age of Top 80 Primary Office Metros

Source: Moody's Analytics CRE, as of Q4 2022.

What does this mean for the future of the office market?

Lower office utilization, higher vacancy rates, and a large number of upcoming lease expirations are all headwinds to the commercial office market. Figure 10 details the primary factors affecting office landlords as a result of the changes in the office landscape. While these factors primarily affect landlords, they will also impact investors.

Characteristic	Trend	Impact
Effective Rents	Lower	Downward Pressure on Revenues
Vacancy	Increasing	Downward Pressure on Revenues
Tenant Improvement Costs	Increasing	Increases Cost Basis
Leasing Commissions	Higher	Increases Cost Basis
Lease Terms	Shorter	Less Predictable Cash Flows
Renewal Probability	Lower	Assumes Increasing Leasing Costs
Downtime Between Leases	Longer	Longer Periods of Lower Revenues
Financing Costs	Higher	Lower Net Cash Flows

FIGURE 10
Trends Affecting Office Landlords

Source: Meketa Investment Group, as of July 2023.

Valuation declines

Capitalization rates ("cap rates") are a valuation metric that represents the yield of a property as a percentage of its value.[13] Cap rates can vary by property type and market and indicate differences in what investors are willing to accept in terms of yield for a particular asset. A higher cap rate indicates a higher expected (or required) return on investment, and vice versa. A sector experiencing declining cap rates is generally thought to be more in favor with investors, as the lower cap rate indicates that investors are willing to accept a lower yield for that particular asset.

[13] A cap rate is computed by dividing annual net operating income by the property's current market value.

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As shown in Figure 11, office cap rates held surprisingly steady during the pandemic, in large part because there was very little transaction activity for appraisers to use in making valuation adjustments. However, as interest rates have risen over the last year, assets are beginning to be written down, which in turn has led to a rise in cap rates.

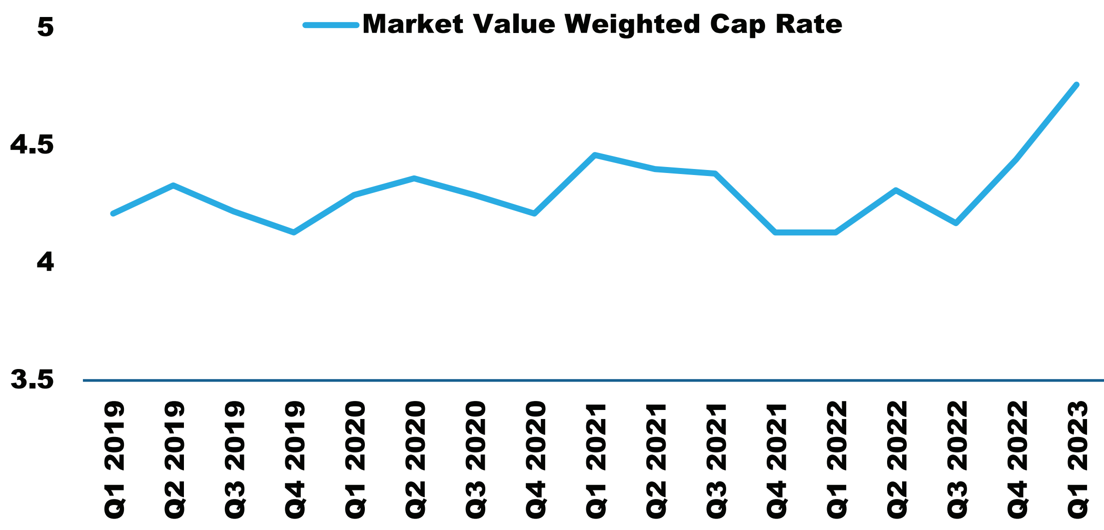

FIGURE 11
Cap Rates for the US Office Sector

Source: NCREIF Trends Report Q1 2023: Current Value Cap Rates.

Loans maturing

Nearly $1.5 trillion of US commercial real estate debt will be due for repayment before the end of 2025.[14] These loans will need to be refinanced at a time when many lenders are tightening their lending standards and may be inclined to reduce or limit their office exposure going forward. As asset values decline, certain office loans may end up "underwater" and require some form of loan balance reduction.[15] There is a heightened risk of default on these loans. In the event of a default, the keys may be handed back to the lender, which may result in distressed asset sales as lenders generally do not want to hold these office assets on their balance sheet.

[14] Source: Bloomberg, "A $1.5 Trillion Wall of Debt Is Looming for US Commercial Properties," April 8, 2023.

[15] A loan is considered "underwater" when the principal value of the loan is higher than the market value of the property.

Office space reduction & conversion

As US office utilization rates remain at approximately half the pre-pandemic levels and hybrid work persists as the new standard, there are early indications that the US may have too much office supply compared to expected future demand. CBRE estimates that 7% of total office space inventory (roughly 700 million square feet) is currently or will become surplus.[16] This surplus will likely be concentrated toward older buildings because of the flight to quality (i.e., positive demand for well-amenitized, newer office properties) noted above.

[16] Source: CBRE, "The Future of Office Space: How the Rise of Remote Work is Changing the Real Estate Landscape," July 2023.

In order to solve this issue of oversupply, there will be some opportunity to reconfigure office properties into other uses. Apartments, student housing, and life sciences facilities are just a few of the wide range of possibilities that current office buildings could be converted into. However, the total US office conversions for 2023, 2024, and

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2025+ represents less than 1% of the total US office inventory. This is because conversions can be time consuming (due to permitting/zoning processes) and expensive. Many office properties would require significant redevelopment to meet the needs of a different functional use.

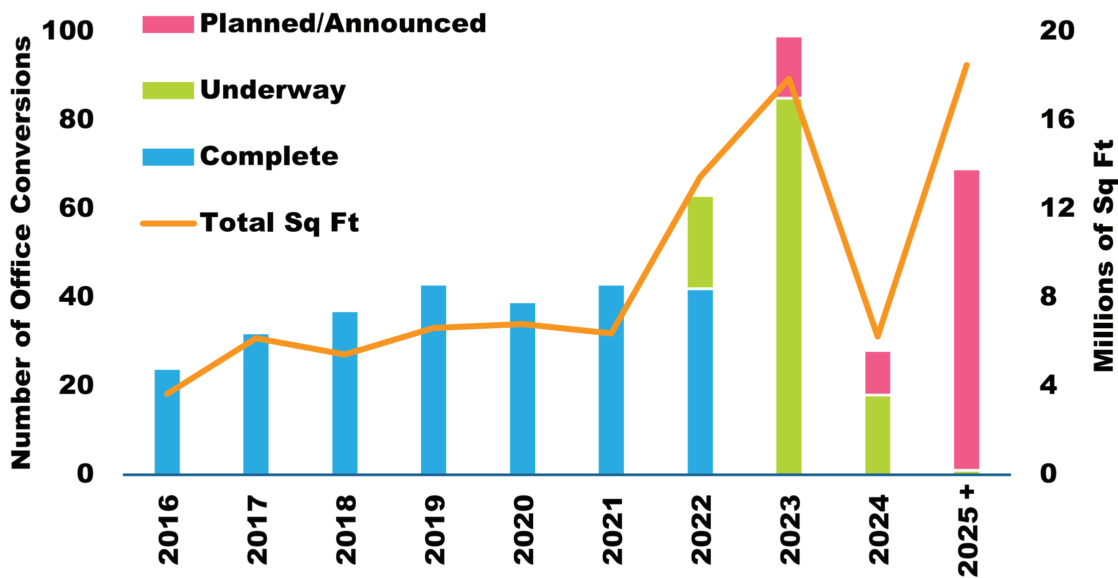

FIGURE 12
US Office Conversions by Estimated Year of Completion

Source: CBRE's US Real Estate Market Outlook 2023, as of Q2 2022.

Conclusion

Hybrid work schedules have become the new normal with employees averaging three remote days per week.[17] This trend has negatively impacted physical office utilization, which has leveled off at approximately 50% of the pre-COVID-19 utilization rate.[18] The good news for owners of office properties is that fully remote work is becoming less common, and employees who work remotely are averaging two days per week in the office.[17] As companies navigate this new environment, office vacancy rates are still above pre-pandemic levels, especially in major US hubs like New York City and Silicon Valley. Leasing activity has somewhat recovered from the COVID-19 drop off, though not back its to pre-pandemic rate. Given economic uncertainty, higher costs of capital, and high construction costs, new development in the office space has declined, thus limiting the new supply coming to market.

[17] Source: McKinsey's American Opportunity Survey, June 2022.

[18] Source: Bloomberg, weekly data as of July 11, 2023. Index used: Kastle 10 US Cities Barometer.

On the positive side, US office-using industries have experienced strong job growth in recent years, with nearly 700,000 more office jobs today than before the pandemic.[19] Despite efforts by the Federal Reserve to slow the economy and bring down inflation, the job market has remained robust. Additionally, there has been a flight to quality as newer properties with attractive amenities in optimal locations are still seeing strong tenant demand.

[19] Source: Bureau of Labor Statistics' Current Population Survey 2022 and 2020, Total Employed Persons: Sales and Office Occupations, as of January 2023. The reports indicate there were 686,000 more employed "Sales & Office Occupants" in 2022 than 2020.

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