July 15, 2020

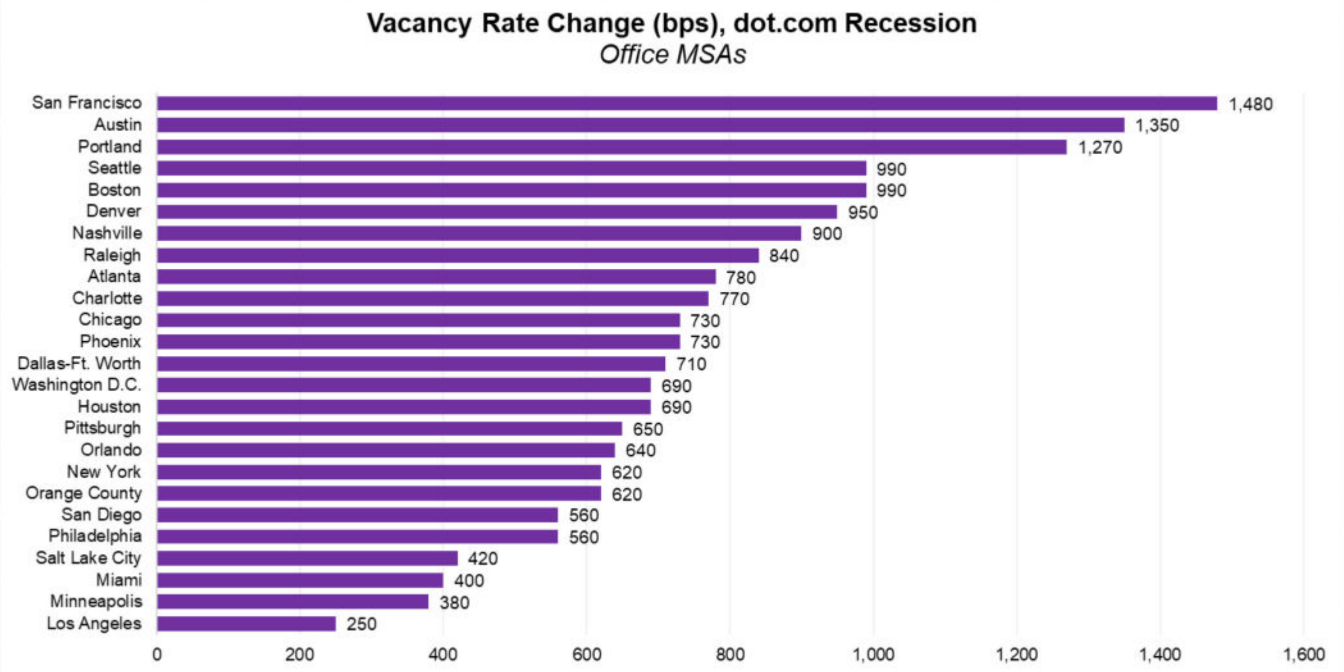
R.I.P. OFFICE. WFH FOREVER! NOT SO FAST

If you are anything like me, you have seen the numerous articles on the future of office employees working from home ("WFH"). After reading these articles, I have more questions than answers. First, four months into a continuing global pandemic (at least in the U.S.), how does anyone know how human behavior will change in the months and years to come? Would you have predicted flying on a plane so quickly after 9/11? Business travelers had very short memories post 9/11. Will office workers have similarly short memories or expect more (or total) flexibility to work from home? Platforms like Zoom, WebEx, Skype, Teams and FaceTime for video conferences were here well before the current pandemic. If video conferencing can replace face-to-face meetings, why hasn't it happened yet? And what about the home office? Not everyone lives in a place with a dedicated office, or even a dedicated space. Home offices take different forms. Where does the professional sharing a small apartment with a loud roommate and Fluffy go to avoid distraction? The next amenity for apartments--a Murphy bed that doubles as a desk?

Working remotely is not a new concept or phenomenon. In 2013, then CEO Marissa Mayer famously required tech firm Yahoo's thousands of employees to return to the office. The reason? A lack of productivity observed during remote working. A recent Gensler survey of 2,300 full-time office workers found that only 12% want to work from home full-time. The study also found that 74% say the people are what they miss most about the office and 55% say collaborating with others is harder at home. Younger generations are less productive at home and less satisfied with the WFH experience the survey discovered. Other surveys have shown the overwhelming majority NEVER want to come back to the office. It depends on the industry and job function. There are numerous advantages to working in an office, including: culture, collaboration, accountability, non-verbal body language, training, socializing and productivity. Flexibility and a hybrid approach of in-office and work-from-home will likely become more prevalent. Predicting human behavior is difficult, and it seems too early to make conclusions about how millions of different companies will handle the future of work.

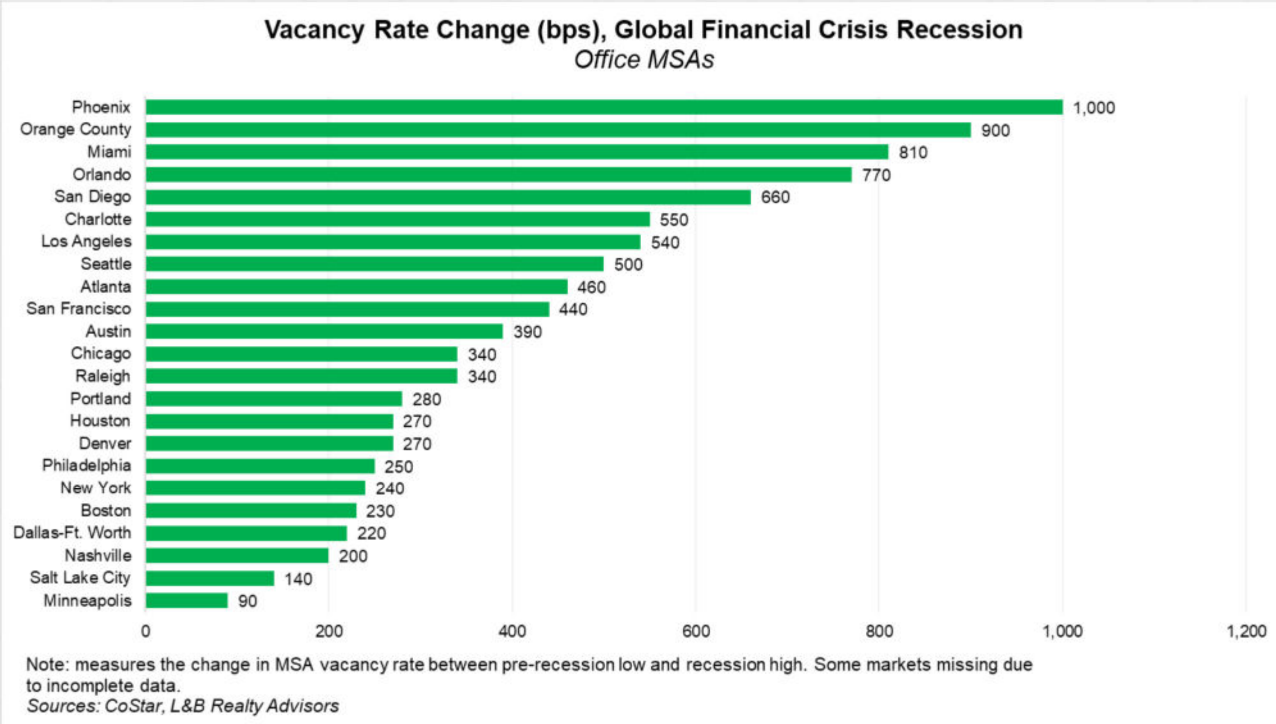
What will tenants do with office space they are obligated to pay rent on for the next 2, 5 or 10 years by contract? Unlike hotels and apartments, which immediately adjust to demand, office buildings with long-term leases and 10-20% annual lease expiration schedules experience new trends incrementally at a glacial pace. Tenants could sub-lease the space, but which firms will lease if everyone is WFH? Companies could redesign their office floorplans to increase the space per employee and enhance the workplace experience. Office space typically accounts for only 5-15% of total expenses for an office-user employer, compared with talent, which can be 70% or more. If businesses are looking to reduce expenses, they will look first to reduce the office employment workforce. As most office employees are not back in the office yet, let's allow those employees to return to the office before prematurely predicting the death of office.

Since none of us knows what will happen in the future, let's reference past downturns and understand which Metropolitan Statistical Areas (MSAs) and cities performed relatively better.

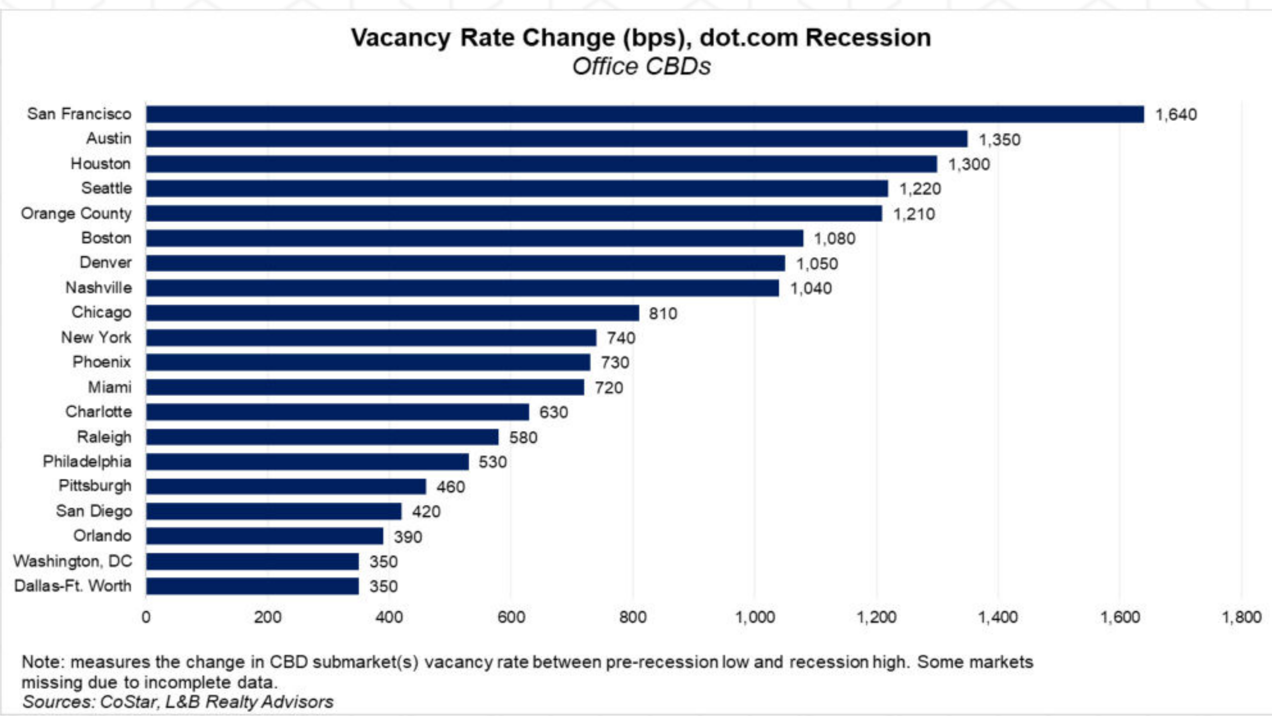


Note: measures the change in MSA vacancy rate between pre-recession low and recession high. Some markets missing due to incomplete data.
Sources: CoStar, L&B Realty Advisors

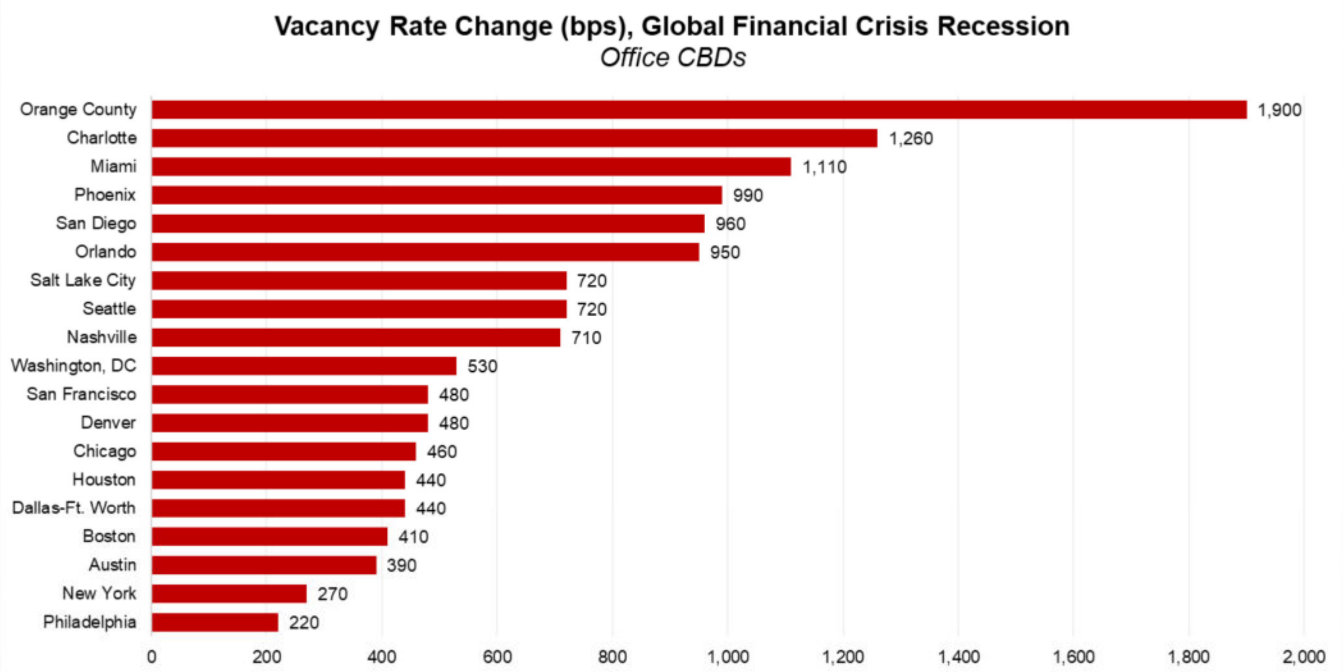
The markets with a high concentration in technology tenants (San Francisco, Austin, Seattle) experienced the most significant increases in vacancy rates. Most of the markets that had the largest increase in vacancy rate also had the lowest vacancy rates at the peak before the downturn. The top five markets are a mix of coastal/non-coastal and West/East. Minneapolis had the lowest vacancy during the recession.



The top four are non-coastal markets. Unlike the early 2000s recession, where technology was hit the hardest, San Francisco and Austin did much better than during the dot.com downturn. The Global Financial Crisis (GFC) hit the markets with a high concentration in the housing sector (Phoenix and Orange County) hardest. Northeast markets (Boston, New York, Philadelphia) performed relatively well compared to the West.



Markets with large concentrations in government employment, like Washington DC and San Diego, performed well. The top 10 markets are mostly non-gateway markets. The bottom five markets are all geographically in the West.



Note: measures the change in CBD submarket(s) vacancy rate between pre-recession low and recession high. Some markets missing due to incomplete data.
Sources: CoStar, L&B Realty Advisors

Surprisingly (or perhaps not) the largest market, New York, did relatively well during the GFC. Austin was near the bottom for the dot.com recession but is near the top for the GFC recession. The Northeast (Philadelphia, New York, Boston) outperformed the West. Texas markets (Austin, Dallas, Houston) are all in the top six.

The only constant in office real estate is change. History can provide helpful lessons, but lessons learned will not predict the future.

- No downturn or economic cycle is the same.
- Short term impact can look very different than long term perspective. Core real estate is a long-term asset class designed to provide income.
- Diversification is key to managing risk in any office portfolio. Diversify by market, tenancy, asset type and suburban versus urban.
- Economic themes evolve over time and demographic trends change quickly, requiring experienced investment management to the nuances of each downturn.

About the author:

Paul Noland is a Vice President in the acquisitions department at L&B Realty Advisors. Mr. Noland is a member of L&B's Investment Committee. Mr. Noland joined L&B in 2004. His responsibilities include sourcing, underwriting, negotiating, and closing commercial real estate investments. Mr. Noland has been responsible for the acquisitions and dispositions of properties valued at over $2.3 billion and totaling 7.0 million square feet. His prior experience included working for Coldwell Banker Commercial, Provident Realty Advisors, and Novotny & Company. Mr. Noland's prior experience includes appraisal, property tax and development. Mr. Noland graduated from Baylor University with a BBA in Real Estate and Management. He is currently a chair of an Urban Land Institute council, member of the International Council of Shopping Centers, and holds a Texas Real Estate License.

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