Office Is The New Retail

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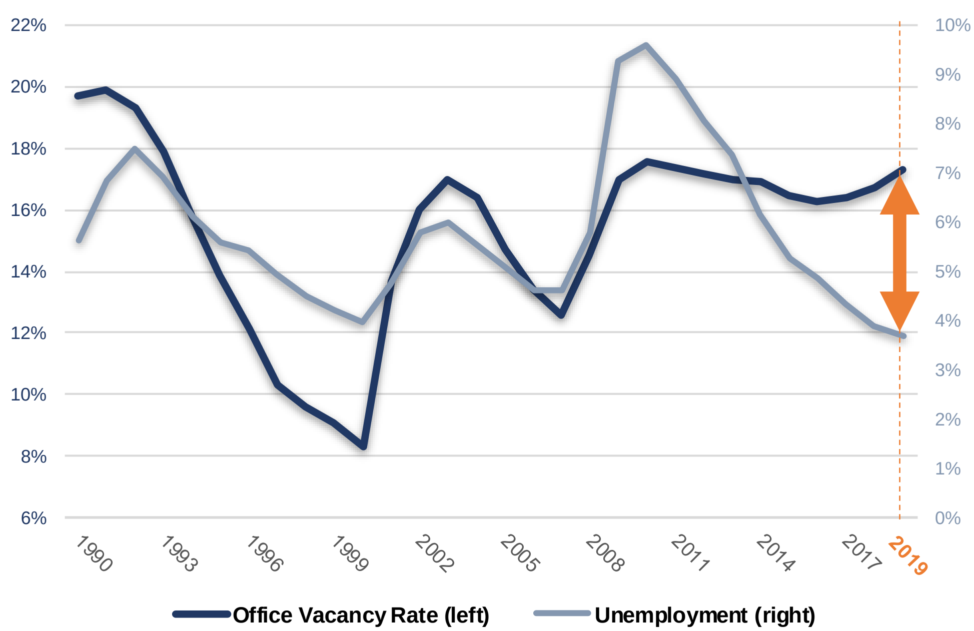
While there has been a lot of publicity surrounding the woes of the US retail property market, the office sector is another place to watch. US office fundamentals are weak, with vacancies well above levels from previous cycles – in fact near peaks of previous recessions – and rising, despite the long economic expansion of recent years and the unemployment rate being near its 50-year low at 3.6%.

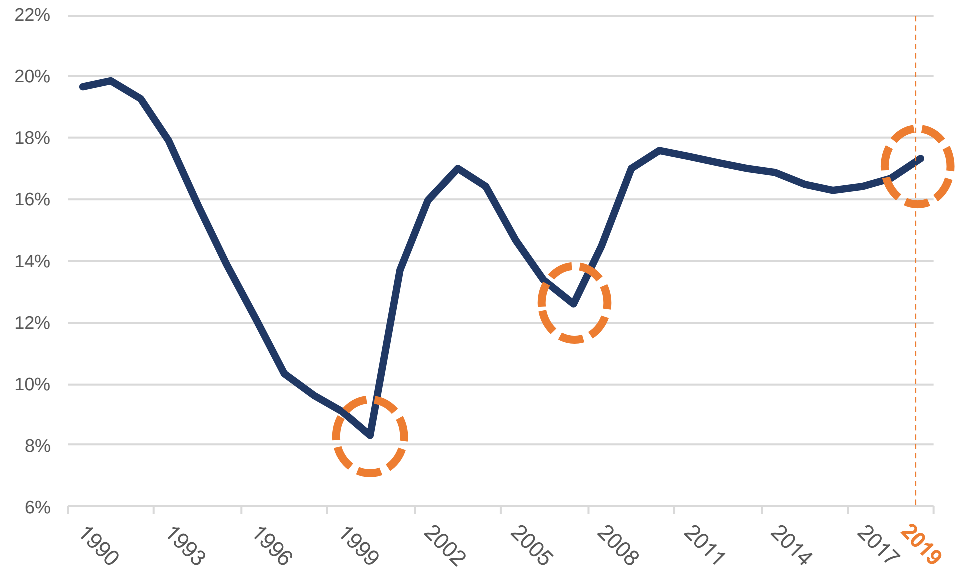
Office Vacancy Rate Record Wide to Unemployment



Source: Reis, U.S. Bureau of Labor Statistics, Mast Insights

This erosion reflects tepid absorption throughout this cycle, even despite a mild supply pipeline that has been well below the level of previous cycles. In 2000, at the end of the cycle, US office vacancies had fallen to 8.3%. The US office vacancy rate bottomed at 12.6% in 2007, prior to the 2008 Global Financial Crisis. In this cycle, the US office vacancy rate reached its tightest level of 16.3% in 2016 (nearly double the low of the long 1990's cycle) and has subsequently risen some 100 bps, to a level above or near the highs of previous recessions.

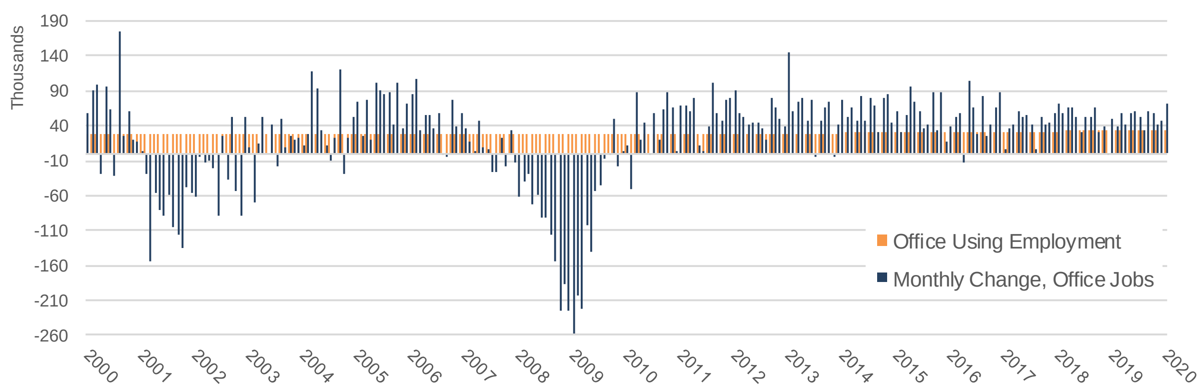
Office Vacanices Are High and Rising Late in the Cycle



Source: Reis, Mast Insights

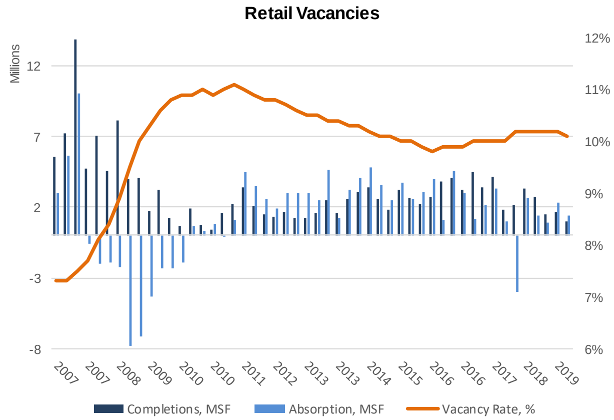
A robust labor market and a long and healthy economic expansion have not generated the relative demand for space that it has in the past. While not as publicized as the secular trends affecting retail, office fundamentals too have been inhibited by secular shifts in space usage. If office fundamentals are unable to thrive amid such conducive labor market conditions, the outlook during a slowdown is particularly concerning.

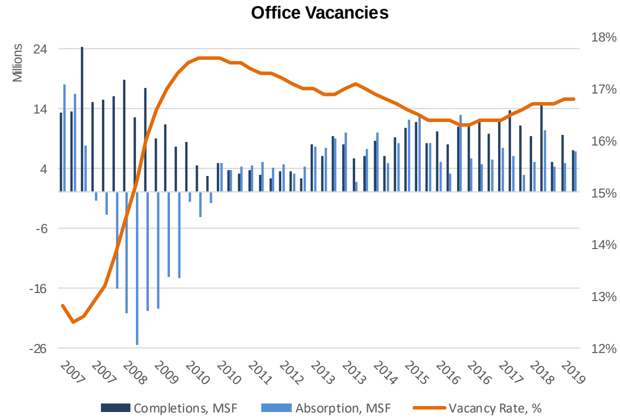
Consistent Growth in US Office-Using Jobs is Failing to Drive Substantial Net Absorption



Source: U.S. Bureau of Labor Statistics, Mast Insights

As the side-by-side charts below depict, the dynamics of the office and retail market have been very similar during this expansion. Both segments are categorized by tepid demand, relatively little new supply, and vacancies that improved stubbornly through the first years of the cycle, bottomed at a high level, and have subsequently risen to levels typically seen during a recession. The supply-demand specifics may vary market to market, but the outlook is poor, especially when accounting for a potential cyclical downturn.





Source: Reis, Mast Insights

> ***Look Similar?***
> *Both retail and office vacancies bottomed a few years ago and are now high and rising despite economic expansion.*

The disconnect between office employment strength and office demand is due to several secular shifts changing the amount of office space being utilized per worker. Like the more publicized changes that are hollowing out bricks and mortar retail – lost share of the consumer wallet to e-retail, changes in consumer lifestyles towards spending on experiences – office demand is being inhibited by technological changes and shifts in "workstyle".

Since the start of this cycle, office space per worker has declined by one-third, falling from an average of 225 square feet to 150 square feet per worker. This decline has not only hampered the take-up of new space but more importantly has squeezed the usage of existing space as tenants have squeezed into less space as their leases expired.

Year	Average Square Feet Per Worker
2010	225
2012	176
2018	150

Source: CoreNet Global, Mast Insights

E-Office

Technology is sapping office space demand in numerous ways. Effectively, in the same way that retail spending has shifted to the Internet, many functions that previously required office space have shifted to the cloud. As firms have shifted to cloud-based servers, there have been myriad implications for office space requirements. Directly, not having physical servers means not needing to dedicate space to them; but the indirect impacts are even greater. With employees toting laptops tied to cloud-based servers, there is far less space need for each worker to actually work in the office. An employee can park at any available desk-like space and work. Space formerly set aside for filing cabinets in offices has disappeared, as documents are kept in the cloud and signed electronically.

In medical offices, the large amounts of space set aside for patient health records has disappeared, with electronic health records in the cloud eliminating the need for that physical space. The digitization of books has prompted the disappearance of law libraries in that important space-using industry. Video conferencing has reduced the size needed for conference rooms. Electronic trading has emptied out formerly cavernous trading floors in the financial industry.

Shifts in Workstyle

Beyond the direct re-shaping of offices that has resulted from technology, the changers in "workstyle"– how and where people do their jobs – that technology has enabled are probably even more important. While the enclosed office became a "dinosaur" some time ago, the shift to open floorplan, long desktop work environments is a hallmark of this cycle. This space-saving layout was enabled by cloud-based laptops. No need for a local PC tower and connected printer and the dedicated wiring that required a specific, larger amount of space for each worker. Of course, firms have taken advantage of the trend toward "modern" offices to squeeze even more space, installing phone booths for private conversations instead of dedicating space to more, larger conference rooms.

In addition to the redesigned modern office, cloud computing has enabled employees to work remotely. This in turn has allowed firms to hotel workspace, having dedicated places in the office for fewer employees than actually work there. The rise of co-working, though the well-publicized issues at WeWork may have taken some of the momentum out of that trend, also results in less use of space, as both startups and incumbent firms – large firms using flexible working spaces include Verizon, Liberty Mutual, IBM, and Amazon --make use of these spaces to avoid long-term space commitments and eliminate the need to warehouse space for future growth. One study estimated that coworking companies often use as little as 65 to 100 square feet of space per worker. In Manhattan, the country's largest office market, WeWork now occupies more office space than any other company, at 5.3 msf. The short duration of these "leases" fundamentally changes the duration profile of office leasing.

Will Coronavirus Hasten the Trend for Office Shrinkage?

Many firms already have flexible work location policies and their prevalence has already been steadily increasing this cycle as a way of attracting and retaining workers. As the coronavirus spreads and health officials press for less social contact as a way to tamp down contagion, the question arises as to whether this becomes an event that shifts the paradigm further? While work-from-home Friday's and other remote options already exist at many firms, companies have remained hesitant on remote work for fear of losing control of employees workflow and diminished productivity. Now the coranvirus outbreak is forcing firms to have employees work from home and if they come to realize that it works well or well enough, the trend toward remote working could accelerate. Employers could adopt a form of airline overbooking, maintaining enough office space for some portion of their workforce to come in on any given day while never expecting full attendance.

Some employers have realized that they have workers in offices that can just as easily perform their jobs remotely, but have not invested in secure laptops and system access because of up-front costs involved. Now in a forced remote working situation, that calculation has reversed, with lost productivity from inability to access systems remotely costing the firms money. If the coronavirus crisis forces these sorts of investments, the likelihood is that these workers will continue to be less office-intense in its aftermath and in the end further the decline of office space needed per worker in the future.

High Vulnerability to Recession

Retail's distress is more obvious today because it is reported with regularity in the form of store closings and bankruptcies. The problems facing the office sector do not get this sort of publicity, but our analysis of the vulnerability of the two segments to a potential recession shows that the dangers exist for office fundamentals. To do this, we modeled a relatively moderate recession in 2020. This scenario is designed to uncover vulnerabilities. As the market's drop and economics activity has begun to slow in the face of the coronavirus crisis, the importance of considering the impact of recession on office fundamentals has become more relevant.

In a moderate recession scenario, the US office vacancy rate could rise to 18.5% by 2021, this compares to a maximum vacancy of 17.6% after the 2008 Global Financial Crisis and 17% in the previous downcycle. The astounding thing about this is that we consider a total drop of just 22 msf in absorption in this moderate recession scenario, when by comparison office absorption hemorrhaged some 140 msf of space in the 2008 Global Financial Crisis. The explanation for this comes down to the technological changes that have left office fundamentals so vulnerable, despite the record-setting expansion we have been in. Prior to the 2008 Global Financial Crisis, office vacancies bottomed out at 12.6% nationally, by comparison, they stand above 17% today. This poor "starting line" suggests US office vacancies could reach their highest level since 1992 under our scenario.

The other interesting comparison is with retail, the poster child for technology weakened real estate. In a moderate recession scenario, retail vacancies rise to 10.6% in 2020. While this is generally considered a poor vacancy level, it is actually below the 11% peak following the 2008 Global Financial Crisis. A key explanation for office's relative weakness compared to retail under our scenario is that retail's well publicized problems have inhibited new supply throughout this cycle. While office completions have been well below the pace of previous cycles, the office market has been characterized by two sets of markets during this expansion: markets that never saw much demand recovery from recession and did not generate a lot of new development as a result, and markets that were strong and prompted new supply. This supply has placed those markets in a position where additions to stock could be met by declining demand and spiking vacancy rates.

What is also difficult to model for office fundamentals is the impact of flexible work spaces on rents during a recession. One scenario, which would also make the vacancy picture worse than we have considered, is that some operators of flex space fail, flooding the market with large amounts of space in one fell swoop, with the issue being most serious in Manhattan where there is more space leased to co-working firms. The less draconian scenario would be that the inherent short-term leases of flex space will see a more immediate hit to overall vacancies, as they have basically attracted the two most variable office users: start-ups and large company overflow space. If this were to happen, one could imagine "fire sale" rent offers by the flex space operators, forcing a worse than anticipated hit to rents in non-flex space. However, while this space will still technically be leased by the flex space operator, it could result in headline vacancy statistics failing to capture a large swath of shadow supply hanging over the market.

Looking beyond an assumed recession to renewed economic growth, the prognosis still remains relatively weak for the office sector in our moderate recession scenario. With absorption projected to average just over 27 msf from 2021 through 2023, vacancies recover to only 17.9% in 2023, still above their level today and higher than during previous recessions. This is a recipe for anemic rent growth, which we would expect to grow well below long-term averages over that time frame.

The burgeoning coronavirus crisis is having an increasingly evident negative impact on the US and world economies. Travel-related industries including hospitality, air travel, cruises, and conferences have had the most immediate fall-off in demand, with the order suspending travel from Europe for 30 days likely to worsen matters. Increasing limits on social gathering is hurting sporting events, concerts and related businesses, with the NBA suspending its season and the NCAA barring fans from the men's and women's tournaments. Firms are cancelling meetings and requiring employees to work from home, further inhibiting economic activity and potentially productivity. Global supply chains are disrupted, and the oil price has plummeted. All of this suggests that our existing scenario of a moderate recession could underestimate the impact on office fundamentals over the next few years.

In order to try to understand the potential downside better, we further modelled a more severe drop in office absorption. We considered a decline in demand of 70 msf nationally through

2021, half the drop of the 2008 Global Financial Crisis. If that were to occur, the office vacancy rate would soar to 20% by 2021, essentially matching the high seen in 1992. Rents would take a much bigger hit under this scenario, registering an all-in decline of 13.5% by 2021 and leaving rents in 2023 still 12% below their current level.

The likelihood of this more severe scenario occurring is a function of the duration of the virus outbreak and it is too soon to know what sort of timeframe we are yet looking at. A cessation of these quarantining measures within months would result in a milder economic impact and ensuing effects on office fundamentals. That said, beyond the immediate short-term impact of the coronavirus crisis on the economy and fundamentals, it is possible that the quarantining measures may show firms that remote work has a lower impact on productivity than expected and more workers will be technology enabled to work remotely, so office space allocated per worker may continue to decline in the coming years.