Whitepaper: A COVID-19 Paradigm Shift in the US Office Market?

The COVID-19 Shutdown has unleashed the latest round of prognostications for Commercial Real Estate. With few deals getting done, its prediction season in our industry, and our inboxes. Among the most popular metaphors prognosticators are serving up is a Paradigm Shift impacting the US Office Market. When you Google “COVID work from home Paradigm Shift” it generates 20 million hits.

For investors, the COVID-19 Shutdown triggered a 27% decline in the FTSE NAREIT Equity Office Index from its January high through August 21, 2020. Brokers report private market buyer pricing expectations that are consistent with the public markets, at down +/- 20%. Will investors recoup these losses? The implications are quite different if they are the result of a Paradigm Shift or temporary correction.

What is a Paradigm Shift?

A Paradigm Shift is a rare, milestone event that triggers disruptive change. The impact is ubiquitous and enduring. Thomas Kuhn is credited with introducing the concept in his book *The Structure of Scientific Revolutions* in 1962. He wrote that “Paradigm Shifts arise when the dominant paradigm under which normal science operates is rendered incompatible with new phenomena, facilitating the adoption of a new theory or paradigm.” Sir Isaac Newton’s work *Mathematical Principles of Natural Philosophy* in 1697 represented a Paradigm Shift by introducing laws of motion that were the basis of physics for 200 years until Albert Einstein’s *Theory of Relativity* in 1905 was a further Paradigm Shift. Paradigm Shifts fundamentally change how we view natural forces or human behavior.

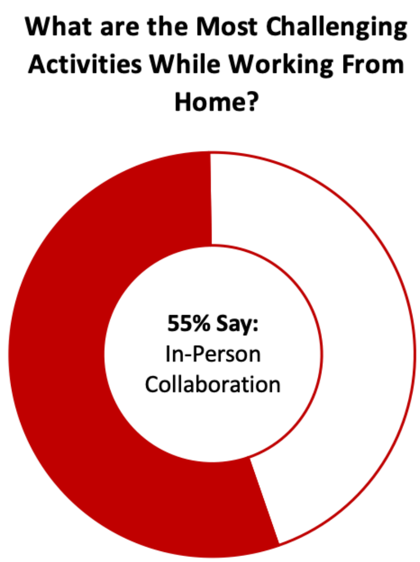
“Paradigm Shifts arise when the dominant paradigm under which normal science operates is rendered incompatible with new phenomena, facilitating the adoption of a new theory or paradigm.” Thomas Kuhn

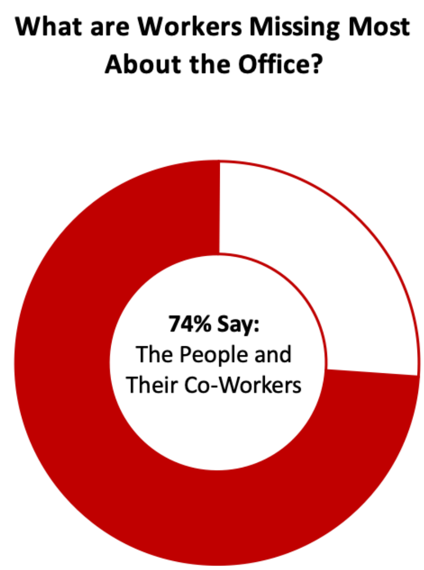
Understanding whether economic change is being driven by a Paradigm Shift or temporary correction has dramatic implications for investors. While both reward those that see them early, they have fundamentally different outcomes. Paradigm Shifts cause a permanent change in asset values, and hence form the basis of long-term investment themes. You cannot outlast a Paradigm Shift if you are on its wrong side and likely will not recover your losses.

Post-COVID-19 Paradigm Shift to Work from Home?

Should office investors be worried that COVID-19 has caused a Paradigm Shift in US white-collar worker preferences toward work from home ("WFH")? And should recent announcements from leading companies in Technology (e.g. Twitter, Facebook) and Financial Services (e.g. Morgan Stanley, Nationwide) that they envision transitioning to a more remote-friendly work-environment signal it is time to take your losses and sell office investments? The early research suggests no.

When Gensler asked respondents if they prefer to work at home, the office, or a coffee shop, the preference was the office. Only 12% of employees reported that they want to work remotely full-time (see Gensler, US Workplace Survey, May 2020). Similarly, a recent Pension Real Estate Association survey found 8% of employees prefer to continue working remotely full-time (see PREA Survey, Industry Conditions in the Wake of COVID-19, May 2020).





Source: Gensler U.S. Work from Home Survey 2020
Gensler Research Institute 2020

Younger Workers Struggling More with WFH

WFH dissatisfaction skews to younger workers who are having a harder time out of the office. Gensler found that Gen Z and Millennials report more difficulty avoiding distractions and maintaining work-life balance then Gen X or Baby Boomers are. Younger people also are more likely to say that they are struggling to stay up to date while working from home (see Gensler, US Workplace Survey, May 2020). In a recent survey of 56,000 people, Cushman & Wakefield found Millennials and Gen Z are struggling with caregiver responsibilities and inadequate WFH workspace (see C&W, Reimagine How & Where the World Will Work, August 2020).

For example, Eastdil Secured has found operating in the Shutdown difficult, as training and instilling culture into younger employees, both critical to their success, are proving problematic in a WFH environment (see Green Street Advisors Conference Call with Mike Van Konynenburg, "Eastdil Secured: Real Estate Deals Amid a Pandemic," July 21, 2020). Not surprising that a recent JLL Survey found a greater percentage of those under 35 are missing the office than those over 35.

Need for Human Interaction

Above all else, what does Gensler report workers miss most about the office: 74% say the people. Dr. Nicole Gravagna argues that Maslow's Hierarchy of Human Needs should be modernized as food, water, shelter, sleep, *others,* and novelty (See Forbes, Nicole Gravagna, "Six Fundamental Human Needs We Need To Meet To Live Our Best Lives," February 5, 2018). WFH tele-infrastructure, productivity tools, and virtual meetings cannot satisfy our basic need for in-person human interaction and collaboration. They also cannot fill a need for bonding and friendship. A Vault.com survey in 2019 found 58% of workers had participated in an office romance at some point in their working lives (see WSJ, "For Newly Remote Workers, Small Town U.S.A. Will Lose Its Allure Soon," June 19, 2020). As the C&W August report concludes, "the office will remain a critical driver of culture, learning & personal connections."

Technology Companies Embrace WFH "Flexibility"

In a competitive world for top talent, will companies offer WFH flexibility? Green Street is assuming yes, as "a significant number of workers will receive WFH flexibility as an employment benefit post-pandemic." (see Green Street Advisors Blog, Danny Ismail, Lead Office Analyst, July 23, 2020). Competition for talent is what we believe drove Jack Dorsey's announcement that Twitter employees can work from home indefinitely. But the great majority of employees will not choose full-time WFH because they do not prefer it.

Leadership at Twitter and Facebook understands that, and hence while both companies are embracing WFH, neither company anticipates reducing their office footprint. On the contrary, Facebook just added to theirs with a 730,000 lease at the Farley Building in New York City (see Bloomberg, "Facebook Signs Lease at Vornado's Farley Building in Manhattan," August 3, 2020).

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Amazon

Amazon just committed to over 900,000 square feet of additional office space across six locations. While the company was early to send workers home when the pandemic hit, management plans to return to the office according to Amazon's Ardine Williams, Vice President of Workforce Development. "The ability to connect with people, the ability for teams to work together in an ad hoc fashion—you can do it virtually, but it isn't as spontaneous. We are looking forward to returning to the office." (see WSJ, "Amazon Bets on Office-Based Work with Expansion in Major Cities," August 18, 2020).

FAANG Major Office Leases – Post-COVID-19 Shutdown

Company	Space Leased	City	Date
Facebook	730,000 SF	NYC	July 2020
Amazon	900,000 SF	6 Cities*	August 2020

*Amazon will expand in Dallas, Detroit, Denver, New York, Phoenix, and San Diego.

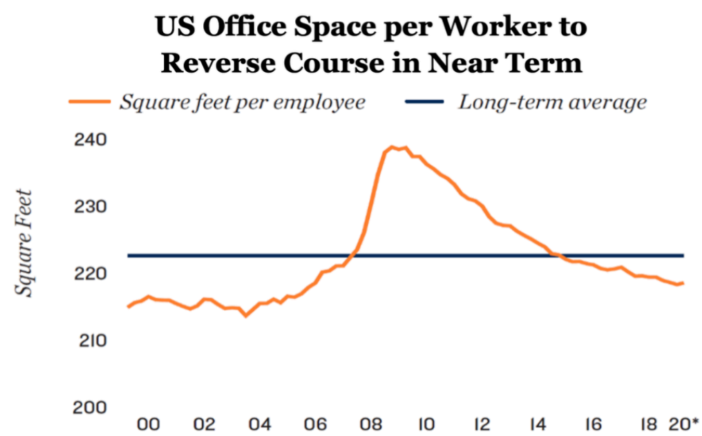
WFH Impact on Office Demand

This is not to claim office demand will be unimpacted WFH, but by how much? Green Street estimates a 10-15% reduction in office demand. Their estimate assumes most employees will still work in the office daily, with a notable increase in those who go to the office regularly but not daily; they note the weighted average number of days per week per employee in the office pre-COVID-19 was 4.6 and will be 3.9 post-COVID-19. A recent Gartner survey of 229 Human Resources managers found 41% of employees will likely work remotely at least part-time post-COVID-19 and there will be a 10% increase in the number that choose WFH full-time. (see Gartner, April 2020),

We think the 10-15% estimate is too high, and the reduction will be neither immediate nor universal. Companies with long-term lease commitments cannot immediately reduce their footprints. According to Moody's Investor Services, most US office leases are eight years or longer (see WSJ, "Companies Start to Think Remote Work Isn't So Great After All," July 24, 2020). The overwhelming majority have opted to renew leases during the pandemic, not downsize. And as Eastdil's Mike Von Konynenburg argues, WFH will be less impactful on high collaboration and client facing work environments, and more significant on functions that are easily transitioned to remote work (e.g. call center and back office functions).

Off-setting Decline in Densification & Hoteling

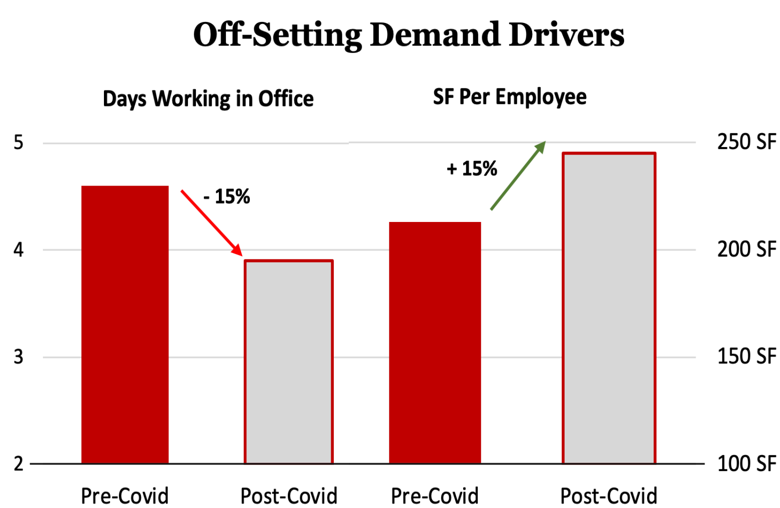
The most significant trend impacting the US office market over the past decade has been the densification of the work environment. To reduce occupancy costs, employers squeezed more employees into shared open workspaces. Green Street estimates space needs per employee declined by 20% and likely shaved 3-4 percentage points off national occupancy over the past decade. With a post-COVID-19 return to the office requiring social distancing, tenants will be unable to maintain that density. The short-term impact of transitioning from low 200's to mid 200's square feet per employee may be more significant than the WFH driven reduction in demand for office space, and more immediate.



*Source Marcus and Millichap Special Office Report 2020

Furthermore, if the significant majority of the decline in office space needs is attributed to an increase in part-time WFH, as opposed to full-time, it will be very difficult for employers to reduce space requirements in a post-COVID-19 return to the office. If one is hesitant to work in a shared office environment 4.6 days a week, why would they be less concerned if they are in the office 3.9 days per week? While Hoteling will not be eliminated, the drive toward shared workstations and open work areas will revert towards dedicated offices and larger cubicles in the short-term.

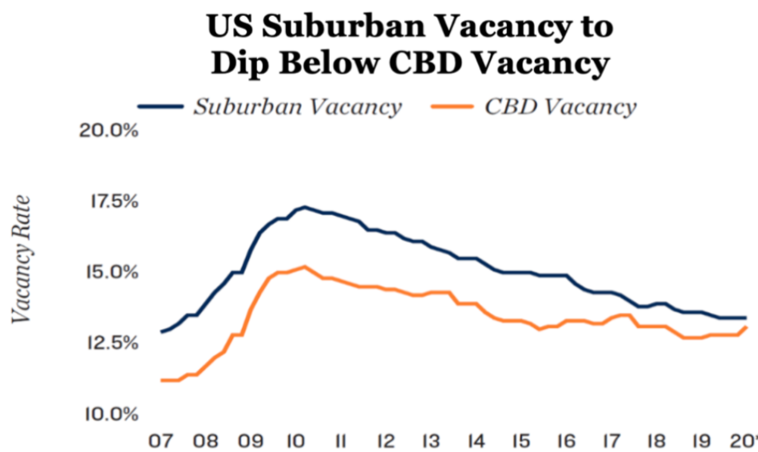
Will Densification and Hoteling return as key trends in office utilization? Of course. COVID-19 will not be here forever, and in the years following mass distribution of an effective vaccine the need for social distancing in the workplace will decline. But expect the bloom on the rose of WFH to fade over time as well. The technologies that are being utilized to support mass WFH during the Shutdown have existed for years. And in a highly



competitive market for talent over the past five years, the world did not embrace telecommuting for a reason. People are less efficient, and employers generally do not prefer WFH. This is becoming clearer with each passing month of the national WFH experiment as pain points become raw. WFH is a temporary fix, not a permanent solution.

The Millennial Effect: Shift Towards Suburban Office

We suspect a more lasting impact of COVID-19 will be an acceleration of a Millennial driven shift in tenant preference for Suburban over CBD office. According to the Pew Research Center, at 72 million people, Millennials have just passed Baby Boomers as the largest US demographic group and represent 35% of the workforce (see Pew Center Research, April 2020). And as the Baby Boomers did, they have begun to leave the urban core and move to the suburbs to raise families. But unlike Baby Boomers, Millennials place a higher value on work-life balance and are accustomed to a walkable living environment. And as any professional parent will tell you, sharing your home with small children does not lend itself to WFH, but it does increase the importance of working close to home.



**Source Marcus and Millichap Special Office Report 2020*
**Through first quarter*

This change started well before the COVID-19. The delta between Suburban and CBD vacancy rates has narrowed to the lowest since the GFC. In 2011, CBD vacancy was 2.3% lower than suburban vacancy; by 2020 that delta narrowed to 30 bps (see Marcus & Millichap, Special Office Report, May 2020).

The Post-Shutdown Office

After a return to the office, we anticipate companies will rethink not only how to utilize their space, but how to locate those requirements. The WFH experiment has highlighted the importance of collaboration *within* groups, but also has highlighted how little collaboration is required *between* groups. “Companies are questioning whether to diversify from a single, large office in a major urban center to a hub-and-spoke model, with one or two offices in urban locations and a handful of outposts in the suburbs. The outposts may shorten commutes for suburban workers while still enabling collaboration and enhancing business continuity” (see PwC strategy+business, “Creating the office of the future,” July 29, 2020).

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> *PwC*

But this will not be a tide that raises all boats. Millennials and Gen Z have become accustomed to amenity rich, energetic work environments, with ample indoor/outdoor common areas. Suburban office properties that offer creative office space in a campus like setting to appeal to younger tastes will out-perform. Particularly those located in sub-markets driven by high collaboration and tenant facing office uses.

The COVID-19 Legacy

The ubiquitous and enduring impact of COVID-19 on the US office market will be the lessons learned from the national WFH experiment. Companies of all sizes now have had months of experience operating remotely. With more time apart, efficiency is waning, and pain points are getting raw. Mission-critical functions are proving problematic as companies report issues with (i) maintaining company culture and identity, (ii) collaborating through shared consciousness and interaction, (iii) lengthening project timelines, and (iv) training the next generation of employees. It becomes clearer with each month that WFH is not the future for the great majority of traditional office functions or workers.

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In the short-term the COVID-19 Recession will trigger a cyclical decline in office market rents and vacancy rates. As all markets are local, the impact will not be ubiquitous. We anticipate CBD office will see a steeper decline than suburban submarkets. The downturn will be longest in 24/7 CBD markets with a high cost of living and recent steep rent increases. For example, San Francisco stands out as particularly vulnerable. CBRE estimates San Francisco had a 6.6% increase in the vacancy rate in the second quarter of this year with the addition of nearly 1.8 million sq. ft. of sublease space, accounting for more than 42% of total available space, compared to 24% in Q2 2019. Meanwhile CBRE's US Metro data show a 70 bps increase in the vacancy rate, and a 30 bps increase in asking rents nationally over the same period.

Rather than cause a Paradigm Shift in demand, the COVID-19 Recession will accelerate trends that were already impacting office markets. And as with previous cycles, the COVID-19 Recession will create distressed buying opportunities. Some property owners will be unable to wait out the cycle. With a bullish view of the outlook for suburban office and confidence in the resiliency of the Southern California economy, we intend to invest in opportunities to capitalize upon the recovery.

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