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Fixed Income Group Research

What return to work means (and doesn't mean) for office space

December 2021

- Since the onset of the COVID-19 pandemic, working from home has proved to be an unplanned but unexpectedly successful experiment for many office workers and the companies they work for. As companies have begun to reevaluate their longer-term space needs, headlines have focused on those that have abandoned their office expansion projects or slashed their space needs. That's led to speculation by some that "the office is dead."
- Demand for office space certainly took a hit from the abrupt shift to working remotely. It resulted in a surge in vacancy rates, shorter lease terms, a dip in renewal rates, and lower rents. However, recent data suggest that negative trends have started to stabilize or even reverse.
- Our research suggests that the office is not going away, it's evolving—with many companies choosing to shift to some form of a hybrid work schedule for at least part of their workforce.
- Whatever happens, there will be implications for investors. "The return to work that is underway is likely to result in a new office normal that will vary regionally and by industry sector," said Vanguard senior credit analyst Mark Lahoda. "Newer, trophy-quality and Class A properties with modern amenities are likely to fare better than older, Class B and C properties in need of renovation—you want an attractive workplace where people feel safe and want to come back to. When evaluating potential investments, underwriting assumptions and required risk premiums need to be adjusted to reflect these differences."

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A look back at the downturn, and why it wasn't worse

As the pandemic intensified, a large part of the U.S. workforce stopped showing up to their offices in the spring of 2020. Between March and April 2020, the percentage of employees working remotely increased from 31% to 62%, according to Gallup.

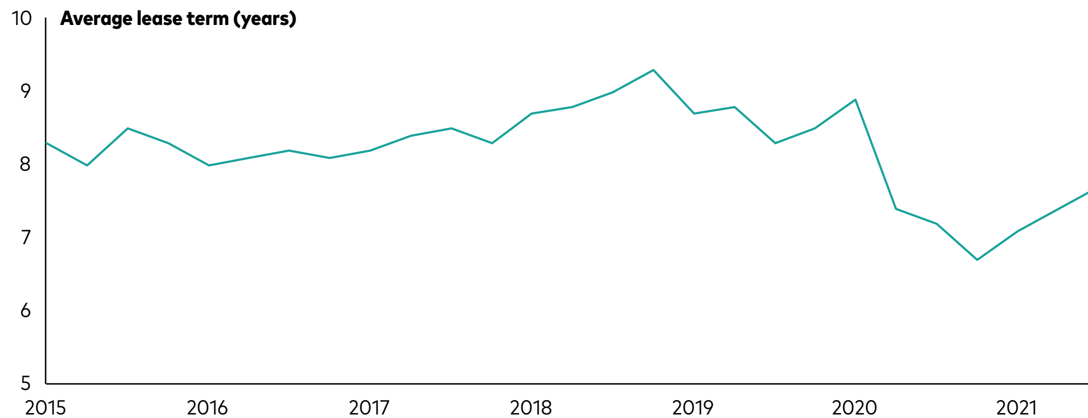
That included 38 million office workers who began telecommuting, according to the U.S. Bureau of Labor Statistics. Still, new office space that was already in the works continued to come online because of the long lead times for construction, which exacerbated market supply. By the end of the third quarter of 2021, the national office vacancy rate had climbed to 17.4%, in line with past recession highs of 17.6% in the third quarter of 2003 and 17.3% in the third quarter of 2010, according to real estate services company Cushman & Wakefield.

Softer demand has also led to a drop in effective rents for office space in 2021 for the first time since 2010, according to national data collected by REIS, a commercial real estate data and analytics company. Across the largest 30 metro areas, New York City and San Francisco were most impacted. Effective rents in the third quarter of 2021 were down 4.9% in New York City and 4.3% in San Francisco year over year.

With corporations uncertain about their long-term office space needs, leasing activity slowed dramatically. As shown in the figure below, employers began opting for shorter leases upon renewal, which pushed average lease terms down to 6.7 years in the last quarter of 2020, compared with 8.9 years at the start of the year, according to real estate services company JLL. As of the third quarter of 2021, the average lease term had rebounded to 7.7 years.

FIGURE 1.

Uncertain office space needs led companies to sign shorter leases, but the trend has reversed



Note: Data are from the first quarter of 2015 through the third quarter of 2021.

Sources: JLL, Bank of America, and Vanguard.

Another encouraging sign that the office is here to stay is that long-term leases (10-plus years) accounted for 43% of transaction activity in the third quarter of 2021, up from a low of 23.6% a year earlier, according to JLL.

The fact that the economic downturn was sharp but short helped mitigate the damage. Because office space leases tend to last for multiyear periods, only a small portion came up for renewal during the worst of the pandemic. And unlike the retail and hotel sectors, office sector delinquency rates, which peaked in June 2020 at 2.4%, have decreased to 1.7% as of November 2021 as most tenants have continued to pay rent, according to commercial property data and analytics company Trepp.

A look ahead at how a hybrid work model could affect demand

It's hard to predict when and how quickly workers will return to the office and how many days a week they'll be there. That challenge was highlighted with the onset of the COVID-19 Delta variant in the first part of 2021, which derailed many corporations' plans to have their workers return to the office by the end of the summer or fall. In part one of its September 2021 *Return to the Office Series* report, Cushman & Wakefield concluded that after herd immunity is reached globally (either 70% of the population vaccinated or infected), most workers would be able to return to the office beginning in the first quarter of 2022. With the recent discovery of the Omicron variant, the timeline for returning may change yet again.

However, some broad trends are beginning to materialize that will affect demand for office space. A hybrid model of work is likely to become the new normal. A survey conducted by real estate services firm CBRE in April 2021 showed that 85% of employees across 18 countries would prefer to work virtually at least two to three days per week. That fits with the approach of many companies to entice workers to stay by having them in the office for only part of the workweek. Being onsite is still believed to be beneficial for interacting with colleagues and leaders; building connections and networks; fostering collaboration, innovation, and career progression; and absorbing the company culture. Interestingly, in a February 2021 report *Leading Teams Forward, Advised by Gallup Remote Work Trends*, Gallup found that employees who work remotely 60–80% of the time are more engaged than those who work exclusively in one place.

A hybrid work model may not dramatically reduce demand for office space, though, and it could even increase demand. The CBRE survey showed that only 9% of companies anticipated making a significant decrease in office space. Pre-pandemic building usage helps explain that low percentage; office buildings were rarely 100% occupied on any given day—60% was generally the norm. Social distancing may also lead companies to reverse the trend in space usage per employee, which had fallen significantly in recent decades—from about 200 square feet per employee in the 1980s and 1990s to 125 square feet today, according to the July 9, 2020, Moody's report *The Future of Office Will Be an Odyssey Not Exodus, With Uneven Credit Implications*. Companies' need for flexible space for collaboration and in-person meetings should also support the demand for office space.

Where U.S. office vacancy rates may be headed

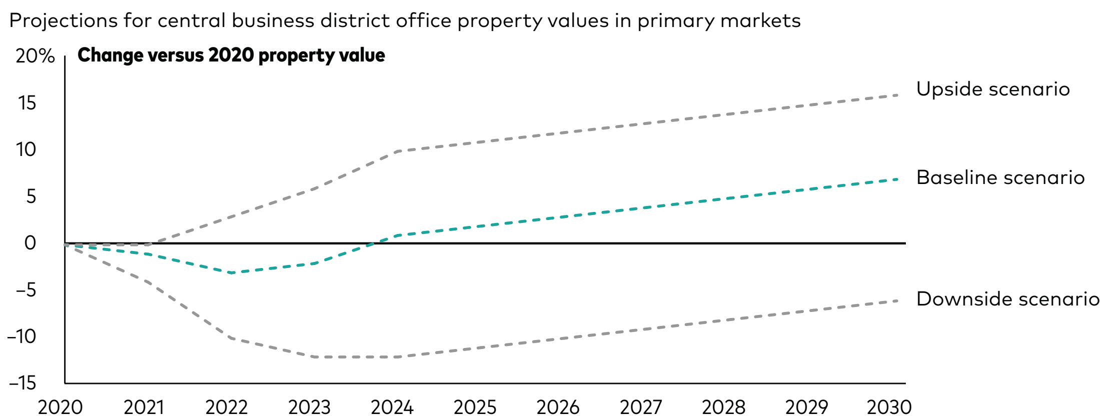
Taking all these factors into account, Cushman & Wakefield, in the September 2021 update, sees office vacancy rates continuing to rise, peaking in mid-2022 at 17.6% then declining but remaining above pre-pandemic levels until at least 2025. Asking rents are expected to follow a similar trajectory, falling by 9.3% peak to trough.

Based on these forecasts, we modeled the potential impact on office property values in primary markets using baseline, downside, and upside scenarios, as shown in the figure below. In our baseline scenario, property values would decrease modestly, by 3%, while under our downside scenario, property values would fall by 12%. In our upside scenario, property values would increase by 10% by 2024.

FIGURE 2.

Vanguard's projections for office property values

Projections for central business district office property values in primary markets



Notes: The primary markets include the top 30 U.S. metro areas by population. Projections are as of December 16, 2021.
Source: Vanguard.

The impact across different regions in the U.S. and at the property level may vary based on market factors, including capitalization rate changes and property-specific factors such as property quality and exposure to near-term lease rollover risk. Another factor that could affect demand and property values is that a portion of jobs can be performed remotely. Nationally, 37% of jobs can be done remotely, according to the National Bureau of Economic Research, and the impact could be greater in some metro areas, such as Washington, D.C. (64.4%), New York (53.9%), and San Francisco (58.4%).

Other factors affecting demand

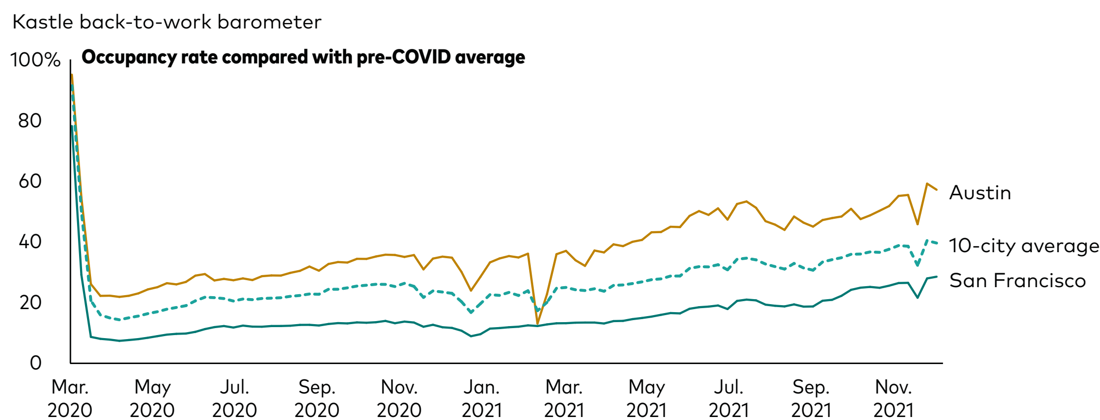
By region, office space in the South is likely to do comparatively well. As detailed in the figure below, mobility data show that more employees are coming back to the office in metro areas that have lower population density, where mass transit is a less common means of commuting to work, and where government regulations have been more limited. This has benefited states such as Texas, where several cities, including Austin, Houston, and Dallas, had employee occupancy rates close to or above 50% as

of December 8, 2021, compared with a national average of 39.8% (which is up from a low of 14.6% as of April 15, 2020), according to keycard data from Kastle Systems, a building access management company.

Other southern cities where worker occupancy rates are climbing fast include Miami, Nashville, Charlotte, and Atlanta. That stands in contrast to more dense metro areas that rely on mass transit and have experienced more government regulation such as New York (35.8%), San Francisco (28.8%), and Washington (35.5%), according to Kastle. Moreover, the Moody's report suggests that, in those dense metro areas, more than 50% of jobs can be done from home, a much higher figure than for the nation as a whole.

FIGURE 3.

Average office building occupancy across 10 major cities



Notes: The 10 cities are San Francisco, New York, Washington, Chicago, Houston, Philadelphia, Los Angeles, Dallas, San Jose, and Austin. Data are from March 11, 2020, through December 8, 2021.

Sources: Kastle Systems, Bloomberg, and Vanguard.

By industry, financial institutions have largely been favoring in-office work, while tech companies have skewed more toward remote work. Part of the reason for this break across industry lines is because financial institutions are highly regulated and have greater security needs.

That said, tech companies continue to increase their office footprints relative to financial companies given their growing workforces and their desire for buildings with the best amenities and lowest environmental impact. Several of the largest office REITs (real estate investment trusts) in the United States have seen an increasing amount of their space occupied by tech companies. For example, these companies accounted for three of Boston Properties' top 10 tenants and 10 of Kilroy Realty's top 15 tenants based on annual base revenues. Overall, tech office space leasing across the industry as a whole was up 122% from January through September 2021, according to Kilroy Realty.

Building quality will be key

Class A office buildings, including trophy buildings, which tend to be new construction or landmark properties, are likely to see stronger demand than those that fall into Classes B and C. Class A properties tend to be of the highest quality and are new or recent builds in prime locations with good accessibility and professional management. COVID-19 has increased their attractiveness because they generally have better ventilation, more common space, more flexible floor plans, more natural light, and better amenities. Convincing workers to return to older Class B and C buildings in need of significant renovations will be a much tougher sell, potentially leading to some of those buildings being redeveloped or converted to other uses.

We are seeing some evidence that the market has started to reflect these differences. For example, according to JLL, trophy and Class A properties have accounted for over 85% of sublease signings since the pandemic hit, as tenants took advantage of opportunities to upgrade to higher quality space at discounted rates.

A recent report from Bank of America and JLL showed that asking rents for Class A properties have slipped by 1.2% from the beginning of the pandemic through the third quarter of 2021, while Class B properties have seen asking rents decline by 4.2%.

Building age is proving to be another determining factor in tenant demand. JLL data on recent lease signings reveal a stronger preference for newer buildings, with properties built after 2015 showing an increase in occupancy over the past 1.5 years and older properties' occupancy declining.

Investment opportunities in this evolving sector

Within the commercial mortgage-backed securities (CMBS) sector, Vanguard invests in both conduit and SASB (single asset single borrower) CMBS. Conduit CMBS securities generally consist of 50 to 75 property loans across several subsectors, and office properties typically make up 25%–35% of the collateral backing the loans in a conduit deal. Although SASB CMBS loans are issued for all major property types, office SASB CMBS are typically backed by large trophy or Class A properties. The office properties backing conduit CMBS typically include a diversified mix of Class A and B and some C properties. Additional underwriting detail is provided for the collateral backing the top 10 to 15 loans in a deal (50%–60% of the total deal balance), which allows us to refine our underwriting and modeling assumptions.

Overall, we are constructive on CMBS fundamentals as the economy continues to reopen. We view last cash flow AAA CMBS as fairly valued relative to single-A corporate bonds. Much of our focus in the coming months will be in identifying pockets of value across the capital structure in CMBS rated AAA, AA, and A to generate alpha. Also, SASB CMBS deals allow for more targeted exposure to specific sectors, including the office sector, which at times can offer attractive relative value opportunities to conduit CMBS.

Office REITs also have advantages to offer investors in the current environment. They tend to hold higher-end property portfolios (Class A buildings) and have a diversified tenant base. Many office REITs are involved in property development, which allows them to be more responsive to changes in demand. During the pandemic. several office REITs have increased their focus on the life sciences office sector, which experienced a rapid increase in demand for lab space because of expanding research efforts to combat COVID-19.

"Investing in office space may be more complex than in the past," said Vanguard senior credit analyst Erick Miller. "This should give active managers with deep fundamental analysis capabilities more opportunities for outperformance."

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Note: Data are as of September 30, 2021.

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