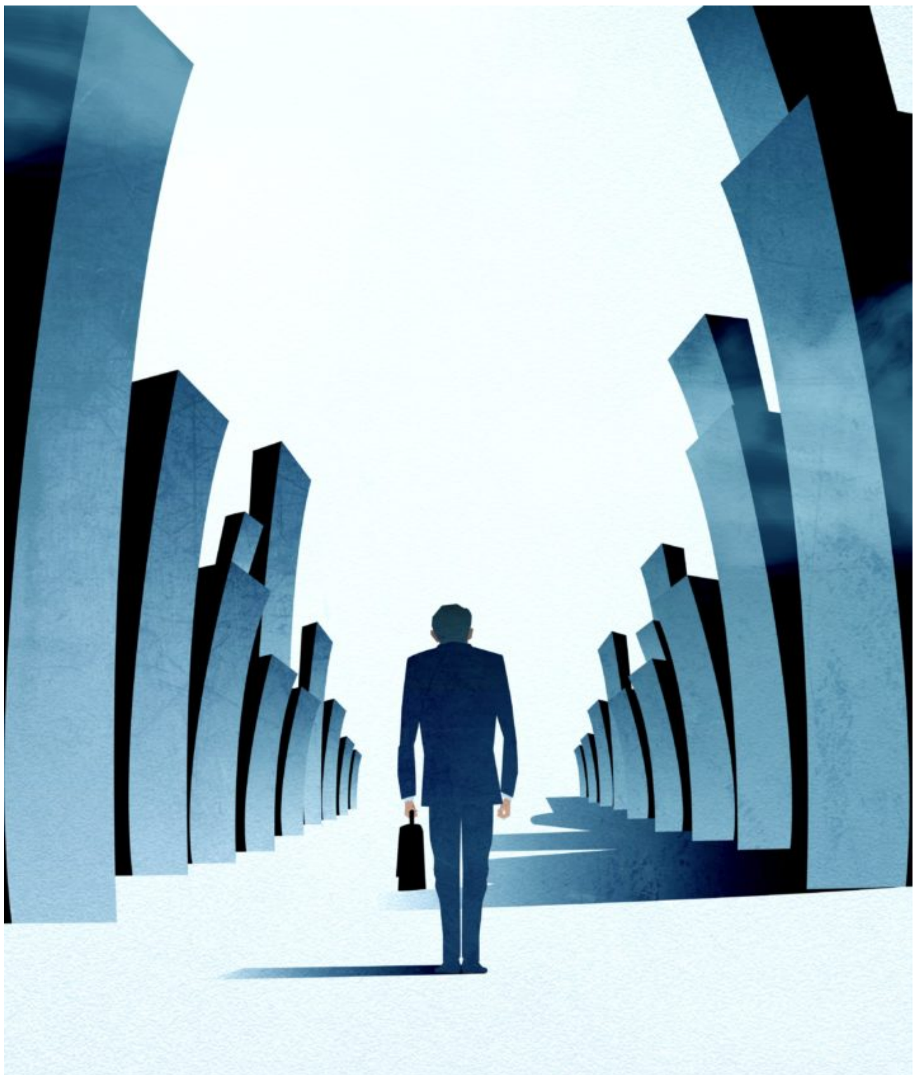
PERE

June 30, 2020

Private real estate's great office headache

Institutional investors and managers are grappling with the underwriting implications of pre-covid office working practices being dumped.

By **Arshiya Khullar**



For over 100 days now, midtown Manhattan, the largest office district in bustling New York, has resembled a ghost town. More than 240 million square feet of workspaces, spread across rows of glossy skyscrapers, have loomed over desolate streets littered with blue vinyl gloves. Mask-clad security guards have been the only people seen inside these buildings, many of which are global corporate headquarters. Before, they were joined by thousands of employees.

The deadly covid-19 outbreak has kept Manhattan's daily workforce – which property consultancy Colliers' estimates at 2.6 million – away from their workplaces since March 2020. As new infections subside, there is hope of a return to normalcy. But whether it will ever be business as usual for offices across Manhattan, and the rest of the world besides, is questionable. In a recent poll conducted by Partnership for New York City, a nonprofit organization, respondents from financial companies and other industries reportedly said they expected only 10 percent of their employees to return to working in the city offices by August 15. By December 31, that percentage would increase marginally to 29 percent.

This presents an existential challenge for office landlords, many of which are institutional capital managers as well. A singular, all-important question looms for them: has the pandemic irreversibly altered the way in which office space is used, and thus, required? Those who believe the answer is yes have a subsequent question to ponder: will there be a resulting reset in how current office holdings and future office investments are underwritten?

> *"Office is one sector most subject to a reset in pricing" Josh Zegen, Madison Realty Capital*

The answer so far depends on who you ask. The world's biggest owner of real estate, Blackstone, recognizes this is a period of flux for the sector and is sitting on the fence. At a New York conference in May, the firm's chairman and chief executive Stephen Schwarzman noted: "What's going to happen to office buildings is actually quite interesting. At this point, the answer is, no one is sure."

Firms with meaningful exposures to offices in their real estate portfolio are, expectedly, more optimistic in their rhetoric. They believe the pandemic has only accelerated trends already underway for years, including a reversal of space densification, decentralization, and a subsequent uptick in suburban office demand. Those based in Asia say cultural differences in working practices and labor laws will drive a faster recovery.

Meanwhile, the naysayers have a more bearish view of declining rents, rising vacancy and the high capex needed to make buildings covid-proof. Richard Mack, co-founder and chief executive of New York-based alternative lender **Mack Real Estate Credit Strategies**, proposes to *PERE* a more radical solution: the tranformation of some office buildings, along with retail and hotel assets, into something else entirely. "This will reduce the amount of obsolete space and then, hopefully, these sectors will become much more interesting," he says.

"In order of magnitude, retail, hotel and office sectors have the most uncertainty," adds Josh Zegen, co-founder of **Madison Realty Capital**, a New York-based private equity firm. "Retail will potentially see a complete shift because it will never come out the way it went in. Hotels are viewed as more cyclical in nature, and, from a supply standpoint, there will be several hotel properties that just do not re-open. The biggest question mark is office." Zegen's hesitance around offices is due to the scale of the sector's possible disruption.

> *In just four months, the decline in office liquidity has already reached 38 percent of the total drop suffered by the sector over a period of 2.5 years, starting in 2007 – MIT Center for Real Estate*

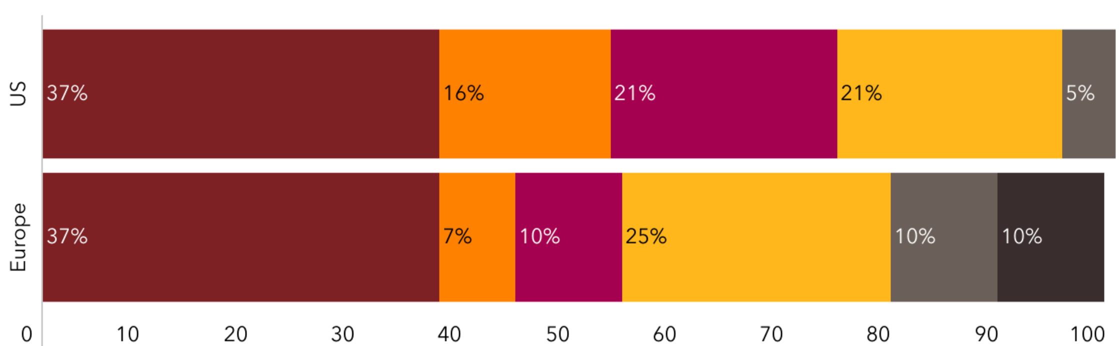
"Office is one sector most subject to a reset in pricing," he says. "Office investments are highly capex focused. And tenants that are in non-payment still have the leverage to ask landlords to reset rents. A lot of landlords will take that into consideration because the alternative means the tenants leave, and now they have new TIs, new leasing commissions, new tenant improvement downtime."

A price reset, but how big?

On the assumption offices reprice, the next quandary is by how much. Few private transactions that closed post March are all based on pre-pandemic assumptions. As Paul Stewart, head of European real estate research at global investment manager Barings, says: "If you are tracking deal flow across markets today, you are almost always looking at what people wanted to buy six months ago."

COLLAPSED DEALS

In Q1 2020, US office sector recorded the most failed deals that fell out of contract, and a similar picture is emerging in Europe



Source: Real Capital Analytics

Tracking failed transactions, on the other hand, reveals more. The US office sector registered the most busted deals in the first quarter, with 37 percent of sales falling out of contract, according to *Real Capital Analytics*. This was worse than the hotel and retail sectors, which each saw 21 percent of transactions collapse. A similar trend is playing out in Europe, where 37 percent of the collapsed deals and pulled offers were for offices as of April 27.

Offices do not fare well in a report published in May by the MIT Center for Real Estate, either. Pegged as the first quantitative study of the pandemic's impact on private real estate, the report analyzes drops in market liquidity by measuring the demand-supply gap in eight US markets. Over the first four months of 2020, average office liquidity dropped 18 percent, compared with 13 percent and 14 percent declines in the more institutionally popular apartment and industrial sectors.

Offices were hit the hardest during the global financial crisis, too. But in just the last four months, the decline in office liquidity has already reached 38 percent of the total sectoral drop over a period of 2.5 years, starting in 2007.

The comparative underperformance of the sector reflects a growing mismatch in price expectations between buyers and sellers. As Jim Costello, senior vice president at RCA, said in a white paper published in May, the current gap is such that a more normal level of deal volume can only happen if owners cut office prices by 12 percent. However, he said many sellers are currently choosing to wait on the sidelines instead of cutting prices.

“Expecting that, suddenly, you will be able to buy office buildings at a 23 percent discount to the prices from last year just because the prices of office REITshave fallen that much is wishful thinking,” he said in the paper.

Marleen Bosma, head of research and strategic advisory Dutch investor Bouwinvest Real Estate, also believes the repercussions of any recession on the Dutch office market, for example, will "likely be less than during the global financial crisis of 2007-08 when the market was characterized by high levels of oversupply," as she noted in a paper published at the onset of the lockdown in the Netherlands in March.

Analyzing future demand

The fundamental issue at the heart of the uncertain future of offices is demand. Grim headlines suggest a major downgrade in occupancies are in in the offing. Japanese bank Nomura's chief executive **told** Reuters in early June he is reviewing whether the staff working at its Tokyo headquarters should be permanently reduced in favor of remote working. On the technology occupier side, Facebook and Twitter have publicly spoken about similar plans. Flexible office providers like WeWork and Knotel, meanwhile, are also downsizing their space as they grapple with reduced demand and the risk of sub-tenant defaults. Knotel, for example, has given up one-fifth of its locations in the US. Amol Sarva, the company's CEO **told*PERE*** in May this was done to "optimize" its portfolio. "The locations we shed may not see strong demand post-pandemic, such as buildings with small elevators and poor ventilation," he said.

According to RCA's *Europe Capital Trends* report, sales of offices with major co–working tenants also tumbled in the first quarter, sliding to just over 1 percent of all transactions from 6 percent in Q3 2019.

"An office asset 100 percent leased to high-profile co–working names is most challenging in the current market environment," says Justin Curlow, global head of research and strategy, at **AXA IM – Real Assets**, the real assets division of Paris-based insurer AXA.

> *"I do not think technology tenants will be leading the charge in terms of working from home, even though that is what the headline suggests" Brandon Huffman, Rubenstein Partners*

Others say using specific cases to presume a permanent reduction in overall office demand is oversimplifying the reality. They point to counter examples within the tech and e-commerce industries. In June, Hong Kong-based private equity real estate firm Gaw Capital Partners completed the acquisition of the Euro America Financial City Tower 6, a 46-story office building in the Chinese city of Hangzhou. A substantial portion of the space had already been pre-leased to e-commerce giant Alibaba's cloud computing division pre-acquisition. The firm's head of China, Humbert Pang, believes the "clustering effect of Alibaba's ecosystem and high-tech institutions in the neighborhood" will help boost office demand despite the economic slowdown.

A month earlier, TikTok, a popular Chinese video-sharing app, also reportedly agreed a 232,000 square foot lease at One Five One, a 48-story building in New York's Times Square. Research by property broker Newmark Knight Frank shows that although leasing activity remained largely frozen, there were still 52 leases signed in Manhattan in May. Asking rents also remained flat at around $81.5 per square foot.

MANHATTAN DURING COVID-19

52 new leases were signed in Manhattan in May and asking rents have so far remained flat

	May 2020	April 2020	Year-ago period
Total inventory	460.5 million sq ft	460.5 million sq ft	450.7 million sq ft
Availability rate	11.7%	11.8%	11.9%
Monthly net absorption	-50,802	98,315	-344,390
Average asking rent	$81.51	$81.80	$76.82
Under construction	16.1 million sq ft	16.1 million sq ft	17 million sq ft

Source: Manhattan monthly snapshot, May 2020, Newmark Knight Frank

Ian Anderson, property services firm CBRE’s Americas head of office research, says most of the firm’s leasing professionals report a significant gap emerging between tenants seeking better deals and office landlords holding their rents steady. However, he does expect national office leasing in the US to rebound roughly in the next two years to pre-recession levels.

“Ultimately, the extent to which companies permanently reduce office space, or have more employees work from home, will likely be countered by an acceleration of tenants ‘de-densifying’ their office space for more social distancing, among other trends,” he says.

Effectively, firms might end up requiring more space per employee, even if the overall office staff is reduced. Facebook, for example, is one major example of a tenant which could need four times more square feet per employee eventually, certain real estate analysts point out.

Contemporary work habits aside, social and cultural factors will also inform a continued need for substantial workspace. Across Asia, multigenerational families living together in smaller-sized apartments is one such cultural factor. Henry Chin, head of research for Asia–Pacific and EMEA at CBRE, says the average residential unit size per capita in Hong Kong is 161 square feet. Even the largest residential units in less dense cities like Tokyo are below 400 square feet. Meanwhile, the workplace density rate, or the average space per desk across Asia, is between 50-130 square feet, while in the US and Europe, the range is 100-200 square feet.

> *“South Korean employers prefer to control employees and have their physical presence at work” Andie Kang, IGIS Asset Management*

“How can we say a decline in office demand will happen in Asia? It will be hard for us to work from home and workplace density is too high.In the short term, companies will need to take up additional space to follow social distancing,” he says.

In Korea, for example, the country's effective coronavirus response has meant fewer concerns about office working. Even at the peak of the outbreak in February-March, there was no nationwide lockdown. The government instead relied on extensive testing and contract tracing to curb infections. This, coupled with the country's distinctive work culture, meant most industries functioned as normal.

"Korean employers prefer to control employees and have their physical presence at work. And given the Labour Act in Korea, it is difficult to fire people, unlike the US which has more flexible labor market laws. So, the office demand has not really been impacted by covid-19," says Andie Kang, co-chief executive and president at Korean asset manager IGIS Asset Management.

In many western countries, employees are expected to drive the decision regarding a firm's future office use. "It is a little bit more complicated than just a business's c-suite deciding they won't have offices," says Curlow. "It is all about the employees and their engagement because they are ultimately the ones doing the bulk of the work. Their desires ultimately drive the need for real estate."

Curlow says the past decade has seen a growing recognition of this trend. "The decision of real estate occupation requirements is not coming from the CEO or COO, but whoever is running the HR department. That is a big factor in terms of talent recruitment and talent retention." AXA IM – Real Assets' own Paris office reopened recently with limited capacity and Curlow says he has noticed employees make full use of the capacity.

"If you let employees choose, everybody is okay working from home when everyone else is. But, once your boss and other decisionmakers are back in the office, those employees will want to go back, too," adds Brandon Huffman, managing principal and portfolio manager for equity investments at **Rubenstein Partners**, a US real estate firm specializing in office investments.

What matters more is the location and the tenant base, he says. “I don’t think technology tenants will be leading the charge in terms of working from home, even though that is what the headline suggests,” says Huffman. “They have been leading the charge, on the opposite front in the last five years by building multibillion-dollar campuses in Silicon Valley.”

Revising underwriting assumptions

Some investors are still actively invest in the sector. Rheinische Versorgungskassen, the pension manager which manages the capital of the civil service pensioners of Germany’s North Rhine-Westphalia region, for example, has continued investing the $150 million separate account mandate it awarded to Boston-headquartered AEW for office and retail investing only in December. AEW acquired an office and retail complex in Paris, valued at approximately €50 million, in May. Marc Langenbach, AEW’s head of funds and separate accounts for Germany, told *PERE* at the time the mandate’s focus would be “core locations, high occupancy and long-leasing with strong covenants.” In another example in May, South Korean pension giant National Pension Service of Korea partnered with Hines to invest $492.2 million equity for a 49.5 percent stake in a major New York office development project. One Madison Avenue is a $2.3 billion development project, spanning 1.4 million rentable square feet, aimed at creating what Scott Kim, NPS’s head of the real estate investment decision, describes as a “market-leading building.”

However, even in a best-case future scenario where there is ample investor interest in the sector and an uptick in tenant demand over the long-term, the consensus surrounding the underwriting of a typical office investment today is that it will nevertheless alter. Office managers will require a more conservative view of short-term cashflows.

AXA – IM's Curlow says: "Firms were previously either taking leasing risk – forward–funding a development, for example – and paying the same price as a standing core asset, or moving into less-established sub-markets without asking for a higher yield as compensation," he says. "It is natural that a correction will force everyone to become more conservative in what they are looking for, both for the equity and debt piece."

A big drag on future performance will be the extra capex required to redevelop and reconfigure buildings, especially older, obsolete office stock. Open-plan offices would need to see improvements including spaced-out desks, upgraded air filtration system, bathrooms and adequate numbers of elevators.

STEADY CAP RATES IN ASIA-PACIFIC

CBRE's survey of investment and valuation professionals indicate no covid-triggered changes in cap rates in core Grade A offices across the region's biggest property markets from March through May

	Low end	High end
Sydney	4.25	5.0
Melbourne	4.35	6.0
Beijing	3.5	4.0
Shanghai	3.5	4.5
Hong Kong	2.5	3.5
Tokyo	2.5	3.5
Singapore	3.25	3.75

Source: CBRE APAC Cap Rate Survey, May 2020

According to research published by consultancy McKinsey entitled "Reimagining the office and work life after covid-19," capital costs, facilities operations, maintenance and management makes real estate the largest cost category for companies outside compensation – amounting to 10-20 percent of total personnel-driven expenditures. The firm projects over time some organizations could end up reducing their real estate costs by 30 percent, as they negotiate competitive facilities management contracts and develop more innovative space designs.

Rubenstein's Huffman says the balance of power and negotiations between landlords and occupiers ultimately determines which undertakes these costs. Retrofitting an existing space in the middle of a lease, for example, is an expensive burden the tenant would assume. If a tenant is negotiating an early lease renewal, however, the landlord could contribute to these costs.

Standard office leases in most gateway markets are eight to 10 years. But the current environment raises questions about how future leases will be structured. Huffman says he has heard of firms taking up space only for a short-term expansion, say three to six months, to bridge the current uncertainty.

"Groups that may have been previously inclined to move into a co–working facility, might negotiate similar leases with their landlord. But the landlord will be getting compensated accordingly for taking on a short-term deal so it will be a win-win situation," he says.

Whether managers increase their due diligence on tenants is also debatable. Huffman says in a bull market, there is not enough focus on tenant credit, but this crisis will force more discipline. Smaller technology start-ups backed by venture capital and private equity firms, for example, will become a riskier bet. "Landlords will be more discerning about high-volatility companies, since we don't share the upside of their businesses, only the downside."

Mack, meanwhile, does not believe underwriting tenants' credit is a complete solution for lending on office properties.

"We have seen tenants that have the best credit in the world become junk in five years. I think it is more about your basis and your debt yield," he says. "Post covid-19, we are going to see some companies we thought were stalwarts end up in financial default, and whatever you thought about credit will go out of the window. But I might add that one can say the same about market occupancy and rents. Everything is subject to significant revision."

Only around 15 percent of Mack Real Estate's loan book is exposed to offices. Mack says he has never loved offices as a lender and his bearish view holds firm. "You have got to assume rents are going to fall for a while until they hit a plateau. Occupancy is likely to fall. The question is: can I get a debt yield where I feel like I have a proper level of cushion making a loan with these two assumptions. That is not easy to do," he says.

"As a lender, if a building ends up becoming empty after spending tenant improvement dollars and leasing commission dollars, I want to know that I have approximately a 200-basis points debt-yield spread to what cap rates are. If I do not have that I either don't want to make the loan, or I want to get paid really well because I feel like I effectively own the equity."

At this point, when no vaccine has been developed and new covid hot zones are still emerging, there are more big picture societal questions than answers. Chief among them is what a return to normal working life would look like. Barings's Stewart says only a "grim medical scenario" and an L-shaped recovery would impact the attractiveness of cities and city centers. Predictably, he is hopeful of a U-shaped recovery.

Stewart's optimism is rooted in history, however. After the September 11, 2001 terrorist attacks that took nearly 3,000 lives and destroyed the iconic twin towers in downtown Manhattan, many New Yorkers felt they would never re-enter an office tower. Then, natural human preferences for interaction and collaboration prevailed. Stewart says: "People will be in a similar status for a period of time now. But, assuming there is a decent medical outcome, a degree of normality will resume."

https://www.perenews.com/private-real-estates-great-office-headache/