



The New Normal: Death of the Office Greatly Exaggerated

August 24, 2020

Key Takeaways

- ▶ The pandemic and subsequent recession have created challenges for office properties, but we are skeptical that work-from-home options will have a severe long-term impact on office usage.
- ▶ The personal relationships and collaboration of employees necessary to sustain a successful corporate culture and support innovation are not easily replicated in virtual environments.
- ▶ After an initial freeze in leasing activity due to COVID-19, property owners in key urban markets are seeing a resumption of lease discussions with new and existing tenants, including potential plans for less dense workplace layouts that will help mitigate more employee work-from-home flexibility.

Work From Home Likely a Limited Headwind

Much has been said and written about the death of the office building in the wake of office space closures required as part of the response to the COVID-19 pandemic and the associated long-term impact of work-from-home (WFH) options; some of this commentary has been from companies in industries such as information technology (IT) that stand to benefit a good deal if WFH becomes the new paradigm. We think there will clearly be an increase in workforce locational flexibility, with the potential use of satellite offices in suburban locations and possibly "hoteling" (where employees don't have a fixed desk, but use an available workstation on those days when they are in the office) to supplement a somewhat higher percentage of WFH activity. However, like the premature reporting of Mark Twain's death, it is far too early to make any well-grounded judgments on the degree of impact that this recent situation will have on future office demand and space configurations.

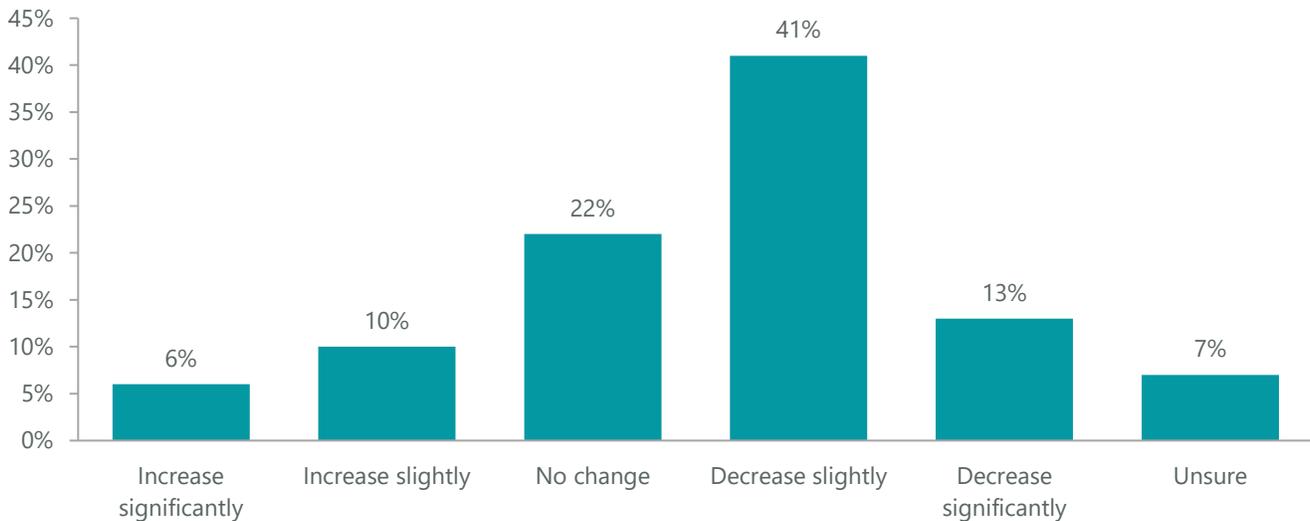
The pandemic and subsequent recession have obviously created short-term demand challenges for office properties, but we are skeptical that WFH will have a severe long-term impact on office usage for several reasons.

- 1. Productivity:** WFH productivity was solid as the lockdowns began and could go higher in the short run as bandwidth and hardware capacity continue to come on-line. People have been intensely focused on work during this crisis both to save their jobs and because "There Was Nothing Else To Do." But eventually we will have vaccines, effective treatments, and/or herd immunity, at which point health/safety reasons for WFH will substantially diminish. And when life begins reverting to normal, distractions will grow such as shopping and errands, daytime social gatherings and taking the kids back and forth to school and activities. The survival of employers and jobs will become much more certain as well and employee intensity levels will likely drop. These issues could negatively affect WFH productivity.

- 2. Ergonomics:** The average residence is poorly configured from an ergonomic standpoint to support two people working from home. This is especially true in urban apartment buildings where tenants tend to occupy smaller units due to the high rents per square foot that they command. Office workers are typically effective in an environment where they have reliable, high-speed Internet connectivity, efficient and comfortable office furniture and a reasonable degree of quiet and privacy that lets them concentrate on the tasks at hand. In two-office-worker households and typical home and apartment layouts, that's often not going to be the case. In addition, WFH for many people can lead to a blending of time perception, such that the work day doesn't really end or is at least harder to end. Commutes, for all their inconveniences, lead to a better daily separation between work and personal life.
- 3. Office Dynamics:** If one assumes that managers will be expected to lead from the front, i.e., they will be expected to be in the office more than their subordinates to set an example, those workers also physically present in the office could be seen as showing greater commitment to the firm and therefore better positioned to influence their bosses, improving their chances to earn future promotions and compensation increases.
- 4. Corporate Culture:** The ability to create or sustain a corporate culture in the long term is critical to successful companies. Applications such as Teams and Zoom are not a substitute for in-person relationships and over time a lack of physical interaction will likely lead to lower employee attachment and higher turnover, resulting in higher costs. Even organizations that have a strong, positive culture and low turnover will see that advantage diminish over time. And for companies and industries that already suffer from higher turnover, this could become a material problem.
- 5. Networking & Innovation:** The negative impact on employee networking and innovation in certain industries, especially IT and pharmaceuticals/biotechnology, could be material. Much innovation in places like Silicon Valley occurs because of serendipitous, informal networking that leads to connections that lead to new business ideas and products. A large-scale WFH culture could largely kill this, decreasing the innovation level in the economy. Owners of properties that cater to the life sciences, such as Alexandria Real Estate Equities, say the push for greater R&D to find a vaccine for COVID-19 and other communicable diseases will support steady long-term demand for research and laboratory space, and innovation in this area thrives on close collaboration. In addition, 38% of respondents to a June survey conducted by the commercial real estate services firm CBRE expect the physical office will remain as important in the post-COVID environment while 41% said the importance of having an office will decrease only slightly.

Exhibit 1: Measuring Importance of Maintaining a Physical Office

In a stable environment, what change in the importance of your physical office will occur?



Source: CBRE Global Research, 2020 Global Occupier Sentiment Survey: The Future of the Office, June 2020.

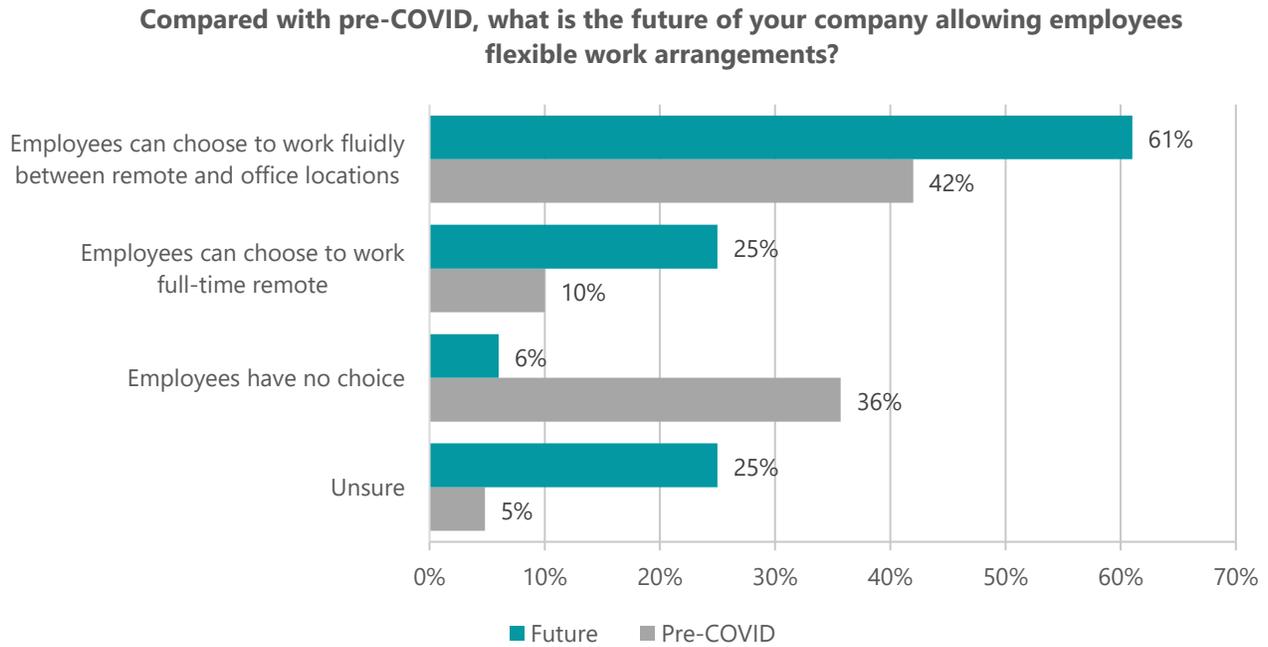
- 6. Health Security and Office Layouts:** Even given some decline in the number of employees needed in the office five days per week, there will be some changes to office layouts to provide “health security” to employees, especially reductions in employee space density. There has been a long-term trend in corporate America of squeezing more employees into a given amount of office square footage as a cost saving measure and to encourage more workplace collaboration. But with likely ongoing concerns about the effect of high density on the spread of illness (it doesn’t have to be a novel pathogen, ordinary influenza is quite communicable), it appears that this trend will reverse and going forward employers will need to lease a larger amount of space to accommodate the same number of office employees. Greater use of partitions and enclosed offices is also a likely response.

Office Space to Adapt, Not Vanish

Managements of some office REITs see this reversal of densification and the need for greater flexibility in workplace layouts as long-term tailwinds for demand, helping to at least partially offset the headwind of greater WFH flexibility. After many companies put new lease and renewal discussions on hold early in the COVID-19 lockdown, owners and operators of properties in key office markets such as New York, Boston and Washington, D.C. are now seeing an uptick in their leasing pipelines, though they are still well below pre-pandemic levels as we are early in the re-opening process. They are also seeing a tenant preference for newer, higher-quality properties over older buildings. While smaller satellite offices in suburban locations closer to where employees live could be an option for some companies based in mass-transit dependent regions like the Northeast, Boston Properties, which operates office buildings in five of the largest urban markets, has yet to see significant interest in suburban or smaller city locations. Respondents to the CBRE survey have expressed interest in the suburban concept but this has yet to show up in real estate transactions.

The WFH option is not going away but will figure into companies’ broader workplace strategy. Sixty-one percent of respondents to the CBRE survey said all employees would be able to work remotely at least part-time.

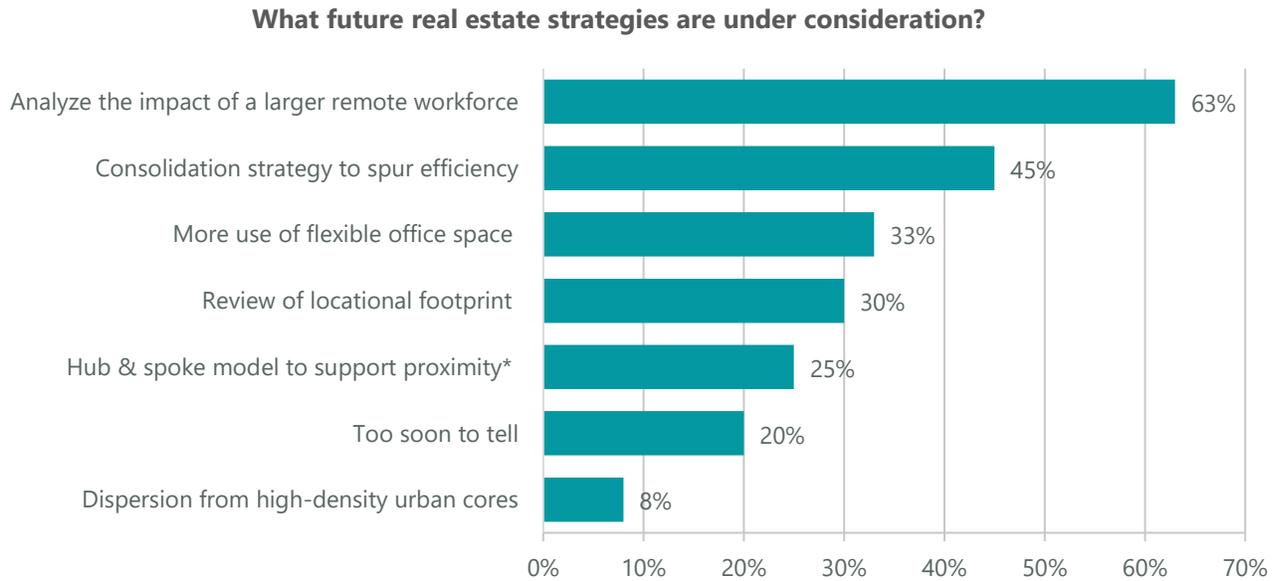
Exhibit 2: Companies Embracing Flexible Work Locations



Source: CBRE Global Research, 2020 Global Occupier Sentiment Survey: The Future of the Office, June 2020.

Going forward, office REITs and other operators of commercial offices will need to be proactive and customer-focused while maintaining the operating sophistication, flexibility and financial resources to adapt to changing circumstances and ensure tenant satisfaction. We also see a greater need for newer, more technologically sophisticated buildings (e.g., up-to-date HVAC equipment and high-speed elevators) with efficient floor layouts to maximize flexibility and minimize additional costs to tenants. Tenants are still in a state of flux as to what their future real estate strategies will be and it will be some time before major patterns emerge, but we think it is unlikely that office space in dense urban markets will empty out (Exhibit 3), though rents will probably need to reset lower over the next few years to reflect the severity of the current economic recession and the adjustments in tenant space plans. We think that owners of high-quality assets (both in terms of locations and physical quality) with strong management will be best positioned to weather these market changes.

Exhibit 3: Multiple Future Workplace Options in the Mix



*Proximity to workforce and customers. Source: CBRE Global Research, 2020 Global Occupier Sentiment Survey: The Future of the Office, June 2020.

There are other risks to an eventual normalization of office markets, especially the fiscal damage to municipal budgets that the lockdowns have caused, which may lead to sharp service cuts and/or substantially higher taxes to balance budgets, both of which can be detrimental to commercial office owners and tenants. There has also been a resurgence in crime rates in some urban areas around the country and we think this will need to be addressed by political leaders. Once the “smoke” from the pandemic clears, it will be critical for cities to maintain the confidence of businesses and their employees in the desirability of being located in an urban environment. Different cities will choose different paths in addressing these issues. But while it is early days, we still see the modern office building as highly likely to adapt to the “new normal,” whatever that might look like.

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