REAL ESTATE ISSUES®

Published by THE COUNSELORS OF REAL ESTATE®

PERSPECTIVE

Office is the New Retail: A Dynamic Property Sector Faces Painful Adjustments and a Bifurcated Recovery

Volume 45, Number 9

May 28, 2021

By Andrew J. Nelson, CRE

Photo: Girts Ragelis/Shutterstock.com

Despite wholly different market dynamics, the office property sector is confronting some challenging adjustments coming out of the pandemic that eerily mirror those buffeting the retail sector.

American office workers are preparing to venture out from their home offices and return to their company offices. But the workplace will not be the same. Most of us won't be commuting in every day. More of us than ever before will rarely return to the headquarters. And many central headquarter offices will go away, replaced by smaller, more dispersed offices.

This reality invites the disingenuous strawman argument from some that "the office is dead." It's not, not nearly, and no one seriously believes it is. But the industry does face some daunting challenges that promise to alter fundamental market dynamics.

THE "DEATH OF RETAIL"

That faulty "office is dead" logic covers familiar terrain concerning the "death of retail." Shopping center boosters often trot out and then shoot down this canard someone points out the severe threats confronting the retail sector. In reality, no one seriously doubts that most people will continue to purchase the majority of their retail goods and services in stores for the foreseeable future.

ABOUT THE AUTHOR

Andrew J. Nelson, CRE, is an independent real estate economist and writer, In addition to his blog at Nelsons Economics, he publishes on Seeking Alpha and Medium, as well as other publications. Previously he served as Chief U.S. Economist for Collier. International and Director, Research & Strategy at Deutsche Asset Management (RREEF). Andrew holds a BA in Economics from Binghamton University and a Master's in City and Regional Planning from the Harvard Kennedy School.

At the same time, it's clear that the sector is undergoing some painful adjustments as it downsizes and adapts to new store locational strategies and evolving consumer shopping patterns. We simply have too much retail space in this country. And an ever-rising share of shopping is moving online, amplified by the exigencies of shopping during a pandemic. Most department stores are likely to close in the coming years.[1] Many, many malls, too, as store closures have topped store openings for several years running.[2]

But not everyone is hurting. Some retail segments are doing quite well (like grocers, home improvement, and dollar stores). Many retail chains and shopping centers are doing record business. Overall, the retail sector is going gangbusters now, with total sales up an astonishing 17% over the prior peak in January 2020. Much of the gains are from e-commerce. But even after subtracting online sales, in-store spending through the end of March was up 10% over the prior peak.

So, the real story is not the "death of retail" but rather the "bifurcation of retail": the large and growing chasm between retail winners and losers. This trend is not new. I personally began writing about this topic more than a decade ago, and I'm sure I wasn't the first.[3] Retail has always been the most dynamic property sector, continually reinventing itself as new concepts and players regularly displace the previous market leaders.

However, this sorting process has intensified in recent years. Even before the pandemic, when the nation was still in the midst of a decade-long economic expansion, retailers were closing stores at rates typical of a deep recession. Blame bankruptcies for some, but most are due to portfolio rationalization as chains revise their business models to prioritize store profitability over store count.

In short, retail is not dying, but neither is everything copacetic. The reality is somewhere in the middle.

ARE OFFICES NEXT?

Now some office building owners are adopting a similar strategy. The hollow "office is dead" argument they love to shoot down goes something like this: "We're never going back to the office because we've all learned that we can work at home just as well." The reality, of course, is that people are tired of working remotely in isolation. We want to put on real clothes. We're social animals who need the interaction of a communal workplace, both for personal fulfillment and professional advancement. And many workers cannot work effectively at home because they don't have the quiet space they need.

Many owners cite a study by the Gensler Research Institute that found that "only 12% of U.S. workers want to work from home full-time."[4] Further, "70% of people want to work in the office the majority of the week." This study, and many like it, are recited as evidence that claims of the "death of offices" are a gross exaggeration. Which, of course, they are. But so is the assertion that offices will return much as they were before once the pandemic passes. They won't.

No one actually believes that we'll all be dressing in our sweatpants for the rest of our working days, seeing each other only on Zoom. That argument does not require serious debunking. But neither does the claim that office demand will revert to their old levels because "most workers want to get back to the office," or even because their firms want them back in the office.

We've invested too much in facilitating working from home. Workers have learned that they can find a better use for the time they formerly spent commuting and preparing for going to the office. And firms are starting to understand just how much they can save on occupancy costs with a hybrid strategy that embraces remote working at least some of the time for at least some workers. We've come too far to unring that bell.

THE INEVITABLE PENDULUM SWING BACK

As with the fallacy of retail's "all or nothing" future, so too the outlook for office demand will fall in between the extremes of everyone working from home and everyone returning to the office full time. But how far will the pendulum swing back to pre-pandemic levels?

It's too early to know for sure, but there's plenty of evidence that we will not get back to where it started. Consider these recent studies:

- In a global Robert Half survey, a third of "professionals currently working from home due to the pandemic would look for a new job if required to be in the office full time."[5]
- A third of Bay Area workers polled by EMC Research say "they will go into a workplace less often after the pandemic is over."[6]
- And two-thirds of respondents to a global survey of office workers by JLL want to work remotely at least once a week, and fully one-third would prefer between three and five days a week.[7]

Thus, if workers have their way, remote working will be an enduring legacy of the pandemic. But what about their employers, who ultimately control office demand? The pandemic precipitated a swift and widespread shift in employer attitudes toward working from home. In PwC's January U.S. Remote Work Survey, 83% of executives "say the shift to remote work has been successful for their company."[8] Most expect working from home to become a permanent fixture of corporate life, though the frequency of remote working will vary tremendously by market, business line, and occupation.

THE IMPACT ON OFFICE DEMAND

Even a modest permanent adoption of remote working could have profound implications for office demand. As firms experiment with more "hot desking," fewer employees will have full-time dedicated workplaces. Workers would come to the office on a rotating basis, reducing the office space required for a given number of workers.

A December 2020 survey of office space decision-makers commissioned by the Building Owners and Managers Association International (BOMA) found "43% seeking to reduce the size of their office square footage, 24% maintaining their current footprint, 9% increasing their size and the remainder being unsure."[9]

An updated global KPMG survey of CEOs provides a more optimistic outlook with "only 17% of global executives looking to downsize their office space as a result of the pandemic," down from the "69% of CEOs surveyed in August 2020 [who] said they planned to reduce their office space over 3 years."[10] Further, "only three in 10 . . . global executives are considering a hybrid model of working for their staff, where most employees work remotely 2–3 days a week."

Few firms will be abandoning offices altogether. That would be the classic strawman argument, as no one seriously contemplates a work world without offices. The clever folks at Green Street conclude, based on their surveys and models, that ultimately around 10% of office workers will always work from home, 30% will never work remotely, and the remaining 60% will be somewhere in the middle.[11]

This conclusion seems broadly consistent with the findings of a study from the University of Chicago that predicts that "22% of all full work days will be supplied from home after the pandemic ends, compared with just 5% before."[12] For Green Street, these work patterns will translate into a 15% reduction in office demand over time. In other words, a material hit to office markets.

THE IMPACT ON OFFICE MARKETS

A long list of major employers already has changed employment policies to embrace at least some level of remote working as a permanent feature or work life, including Salesforce, Spotify, Twitter, and Microsoft, among many others.[13, 14, 15, 16] Some have announced plans to reduce their office footprint, including JPMorgan Chase and Deutsche Bank, specifically because they expect (or will require) many of their professionals to work remotely at least part of the week.[17, 18]

You'd never guess at the turmoil roiling office markets from looking only at headline occupancy data. Cushman & Wakefield pegs the 1Q21 national "vacancy" rate (really, unleased space) at 16.3%.[19] That's up 340 basis points over the last year to its highest level in a decade. But considering how many firms shut their offices during the pandemic – many of which are still closed – the wonder is that these figures aren't even higher.

Dig deeper, however, and the reality is not as sanguine. Office market trends generally do not shift quickly due to the long lease terms typical for office space. But sublease market data can presage what's coming. JLL reports 151 million square feet of sublease space was available nationally at the end of Q1, up over 60% from early 2020.[20] More telling, that's 22% above the previous high-water mark reached in 2002. And all that's on top of the 125 million square feet of negative net absorption over the past four quarters, reflecting both reduced leasing activity and more leases being allowed to expire.

Since tenants offer up their excess space for sublease, this metric provides insight into future leasing intentions. After the Great Financial Crisis (GFC) that started in late 2008, leasing was tepid for much of the following decade-long expansion due to the tremendous overhang of "shadow" office space – unoccupied space that's not technically available to the market. By my rough estimate, firms leased half as much additional space per new office worker as usual in prior expansions.

With twice as much sublease space on the market now as at the peak of the GFC, and the baseline vacancy rate already approaching its GFC peak, we can expect vacancies to soar to new peaks this year and next as leases expire and firms recalibrate their future space needs. The next few years will be difficult as markets sort to new equilibrium rent levels required to fill the empty space. Strong expected economic growth this year and next will provide only a partial offset.

A BIFURCATED DOWNTURN . . . AND RECOVERY

Despite some obvious differences in their market dynamics, both the office and retail sectors have suffered during the pandemic for broadly similar reasons: each sector depends on social interaction as an essential feature of their function. Along with the hospitality sector, office and retail both sustained expensive losses as our economy shut down and we all retreated to the safety of our homes.

But as we emerge from our cocoons, the office sector shares another key attribute with retail: the bifurcated fortunes of different segments and markets during the recovery and going forward.

Just as the pandemic accelerated retail trends already in place that favored e-commerce at the expense of department stores, apparel stores, and interior malls generally, so too, we're witnessing a bifurcation between winners and losers in the office space. This emerging trend marks a sharp contrast to historical patterns. Though there's always variation in how the office market in different metros performs over the cycle – some Sunbelt markets maintain persistently high vacancy rates, for example, while some coastal markets are consistently below average – office markets generally rise and fall together more uniformly than do other property sectors. (For the technically inclined reader: Relative to their mean vacancy rate across metros, office markets tend to have the lowest standard deviation, a concept known as the "coefficient of variation." The same holds for rents.)

Not this time. There's now a much more significant variation among metros than in typical downturns. Most notably, less expensive metros are gaining at the expense of pricier metros, even if media accounts routinely exaggerate the growth in migration.

Some segments, especially tech and finance, got hit harder because they have a greater share of professionals who can work remotely. As it happens, many of the pricy metros most concentrated in tech and finance are in blue states with the most severe and prolonged COVID restrictions, providing a triple whammy to those office markets. Thus, San Francisco and New York have both suffered double-digit increases in vacancy rates, while vacancy rates rose less than five percentage points in Atlanta and Dallas. (Though, to be fair, vacancies in these sunbelt markets started out much higher than in the gateway markets, and they remain higher to this day.)

However, the vast majority of residents exiting expensive cities do not move to new metros but rather migrate to elsewhere within their region because they are not fully untethered from their workplace.[21, 22] They need to come into their office at least occasionally, usually at least once a week, limiting how far they can reside from their base office. Interstate moves rose modestly during the pandemic but are still relatively rare and migration rates remain below those in prior decades. That goes doubly for corporate relocations, despite several high-profile announcements.[23] Few firms up and move from one state to another.

But even these intraregional trends are in sharp contrast to migration patterns during the last few decades. Occupancies and rents typically have declined more in suburban markets than in CBDs during recent recessions as office tenants exploit falling rents to trade up for better, more centrally located space. During the last cycle, CBDs far outperformed their suburban counterparts, falling less during the recession, then recovering sooner and growing faster during the expansion.

The exact opposite seems to be happening now, however. Both office and apartment tenants are trading down for less expensive space beyond downtown neighborhoods. This migration partly reflects the aging of millennials, who are now ready to raise families and need more space. Their employers are following them to less dense and less expensive office space outside the CBDs. Some firms are experimenting with a "hub and spoke" locational strategy to replace the traditional CBD headquarters: less costly for the firm, shorter commutes for the workers.

Surely downtown office markets will recover as pandemic restrictions ease, urban amenities like restaurants and entertainment reopen, and former city-dwellers return to their old neighborhoods. But likely not nearly to their prior levels, if survey data are to be believed.

A TECH-ENABLED SHIFT

The market shifts we're seeing in the office sector share one other key trait with those in the retail sector. Both are facilitated by advances in technology. In retail's case, nonstore shopping required dramatic advances in not only the mechanics of shopping online, but also the logistics of how goods move from manufacturer to consumer.

Similarly, for employees to be efficient and effective working away from the company office required innovations in how we communicate and collaborate offsite. Video calling apps like Zoom and Google Meet grew from niche products to essential business tools. At the same time, firms sharply expanded their use of collaboration software like Microsoft Teams and Slack. And firms and their workers have invested to upgrade their broadband capacity to handle all the additional bandwidth needed.

With these investments, companies today are far more prepared to support remote working than before the pandemic. Moreover, with this improved infrastructure, firms will be reluctant to revert to their old ways of doing business, particularly when they can reduce occupancy costs by using less – and less costly – space.

This development is particularly ironic and painful for tech markets, which have thrived based on their very proximity to one another. Leveraging what geographers call "economies of agglomeration," tech markets attract a disproportionate share of talent and investment. Now the very products they developed are facilitating their decline.

AND SOME IMPORTANT DIFFERENCES

The parallels with the retail sector can be stretched only so far. Though we use the term "bifurcation" to describe the diverging fortunes within each sector, outcomes tend to be more binary (winner or loser) in retail than in office, particularly for individual assets. A failing shopping center can enter a death spiral where rising vacancies trip "go-dark" and "co-tenancy" clauses that no amount of rent concessions can save. By contrast, a vacant office building usually can attract new tenants simply by reducing rents, though the repositioning may entail a financial hit and expensive renovations. As a result, shopping centers are more prone than office buildings to endure high, persistent vacancies.

Office markets also have many more assets at more price points than do retail markets. Thus, it's often easier for an office building to find its position along the price/quality continuum and shift up or down as market conditions dictate. With more options for market pivots, outcomes are less "winner take all" than in the retail sector. Recently vacated offices in tech and other gateway markets can find new life with different tenants, though likely at lower rent levels.

Finally, the office sector is much less overbuilt than the retail sector. While individual office markets are prone to regular bouts of cyclical oversupply, the office sector overall has not experienced the perennial overbuilding that plagued the retail sector for the two decades leading up to the GFC. Nor is the office sector likely to suffer nearly as much demand erosion as the retail sector.

These fundamental differences suggest that the office sector will not suffer nearly the same degree of fallout as we expect in the retail sector. Still, the uncanny similarities between the two sectors imply that the office sector faces some challenging adjustments coming out of the pandemic. •

ENDNOTES

1. Lauren Thomas, "Over 50% of Department Stores in Malls Predicted to Close by 2021, Real Estate Services Firm Says", CNBC, April 29, 2020, https://www.cnbc.com/2020/04/29/50percent-of-all-these-malls-forecast-to-close-by-2021-green-street-advisors-says.html.
2. Lauren Thomas, "25% of U.S. malls are expected to shut within 5 years. Giving them a new life won't be easy", CNBC, Augut 27, 2020, https://www.cnbc.com/2020/08/27/25percent-of-us-malls-are-set-to-shut-within-5-years-what-comes-next.html.
3. Andrew J. Nelson and Alex Symes, "Done Shopping – Structural Shifts in the U.S. Retail Sector and Their Implications for Real Estate Investment", RREEF Reasearch, Number 72, June 2009, Available at: https://nelsoneconomics.com/wp-content/uploads/2019/10/Research_Done_Shopping_June_2009.pdf.
4. "Working From Home Reinforces the Benefits of the Office", Gensler Research Institute, https://www.gensler.com/us-wfh-survey-2020-wfh-reinforces-the-benefits-of-the-office.
5. "1 In 3 Remote Workers May Quit If Required To Return To The Office Full Time, Robert Half Survey Finds", Robert Half International, April 6, 2021. https://rh-us.mediaroom.com/2021-04-06-1-In-3-Remote-Workers-May-Quit-If-Required-To-Return-To-The-Office-Full-Time-Robert-Half-Survey-Finds.
6. EMC Research, Bay Area Council Poll, March 2021, https://www.bayareacouncil.org/wp-content/uploads/2021/04/21-8072-BAC-COVID-Vaccine-hesitancy-3.29-6.pdf.
7. "Global workforce expectations are shifting due to COVID-19", JLL, November 17, 2020, https://www.us.jll.com/en/trends-and-insights/research/global-workforce-expectations-shifting-due-to-covid-19.
8. "It's time to reimagine where and how work will get done", PwC, January 12, 2021, https://www.pwc.com/us/en/library/covid-19/us-remote-work-survey.html.
9. "Groundbreaking Nationwide COVID-19 Impact Study Finds Commercial Real Estate at a Critical Inflection Point", BOMA International, December 1, 2020, https://www.boma.org/BOMA/Research-Resources/3-BOMA-Spaces/Newsroom/Press_Room/2020/PRCOVID19IMPACT.aspx.
10. "Nearly half of global CEOs don't expect to see a return to 'normal' until 2022: KPMG study", KPMG, March 23, 2021, https://home.kpmg/xx/en/home/media/press-releases/2021/03/nearly-half-of-global-ceos-dont-expect-a-return-to-normal-until-2022-ceo-outlook-pulse.html.
11. "Deurbanization: A Tale of Three Cities", Green Street, April 15, 2021, https://www.greenstreet.com/insights/blog/deurbanization-a-tale-of-three-cities.
12. Jose Maria Barrero, Nicholas Bloom, and Steven J. Davis, "Why Working From Home Will Stick", Becker Friedman Institute for Economics at The University of Chicago, April 22, 2021, https://bfi.uchicago.edu/working-paper/why-working-from-home-will-stick/.
13. Brent Hyder, "Creating a Best Workplace from Anywhere, for Everyone", Salesforce.com, February 9, 2021, https://www.salesforce.com/news/stories/creating-a-best-workplace-from-anywhere/.

14. Anna Lundström and Alexander Westerdahl, "Introducing Working From Anywhere", Spotify HR Blog, February 12, 2021, https://hrblog.spotify.com/2021/02/12/introducing-working-from-anywhere/

15. Jennifer Christie, "Keeping our employees and partners safe during #coronavirus" Twitter Blog, May 12, 2020, https://blog.twitter.com/en_us/topics/company/2020/keeping-our-employees-and-partners-safe-during-coronavirus.html.

16. Kurt DelBene, "The philosophy and practice of our hybrid workplace", Official Microsoft Blog, March 22, 2021, https://blogs.microsoft.com/blog/2021/03/22/the-philosophy-and-practice-of-our-hybrid-workplace/.

17. "JPMorgan To 'Significantly Reduce' Global Office Footprint, CEO Says", Bisnow, April 7, 2021, https://www.bisnow.com/national/news/office/jpmorgan-significantly-reducing-office-footprint-remote-work-jamie-dimon-108431.

18. "Deutsche Bank could move half its NY staff to smaller hubs", The Real Deal, December 14, 2020, https://therealdeal.com/2020/12/14/deutsche-bank-could-move-half-its-ny-staff-to-smaller-hubs/.

19. Kenneth McCarthy, "U.S. Office MarketBeat Reports", Cushman & Wakefield, April 15, 2021, https://www.cushmanwakefield.com/en/united-states/insights/us-marketbeats/us-office-marketbeat-reports.

20. Phil Ryan, "United States Office Outlook - Q1 2021", JLL, April 20, 2021, https://www.us.jll.com/en/trends-and-insights/research/office-market-statistics-trends.

21. Jed Kolko, Emily Badger and Quoctrung Bui, "How the Pandemic Did, and Didn't, Change Where Americans Move", *The New York Times,* April 19, 2021, https://www.nytimes.com/interactive/2021/04/19/upshot/how-the-pandemic-did-and-didnt-change-moves.html.

22. Arjun Ramani and Nicholas Bloom, "The donut effect: How COVID-19 shapes real estate", Stanford Institute for Economic Policy Research, January 2021, https://siepr.stanford.edu/research/publications/donut-effect-how-covid-19-shapes-real-estate.

23. Matt Rossoff, "Ignore the tech naysayers — San Francisco isn't dying", CNBC, December 24, 2020, https://www.cnbc.com/2020/12/24/san-francisco-isnt-dying-despite-tech-departures.html.

CRE®
THE COUNSELORS
OF REAL ESTATE®

www.cre.org

REAL ESTATE ISSUES®

Published by THE COUNSELORS OF REAL ESTATE®

Since its launch in 1976, *Real Estate Issues* has been the premier forum in which the world's foremost real estate thought leaders present innovative ideas, novel strategies, and intriguing commentary on all matters relating to real property.

Visit www.cre.org/rei to view the digital archive of *Real Estate Issues* articles.

Subscribe at www.cre.org/subscribe to receive digital or print editions of *Real Estate Issues*.

Please submit any comments to the *Real Estate Issues* Executive Editor (or Board) on this article to rei@cre.org.