Location, Location, Vaccination

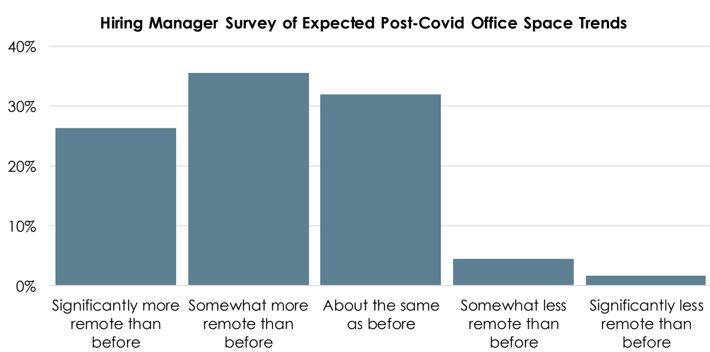
August 2020

OVERVIEW

- **The pandemic dramatically accelerated the move from traditional office environments to work-from-home for most American office workers**
- **It is clear that a significant portion of workers will move from a five-day in-office work week to something else**
- **Recognizing, navigating and adapting to the new office environment will be key to successful investing in the sector**

Background

One of the unforeseen consequences of the Covid-19 pandemic is the sudden shift in our ability to access and work in office buildings. Many firms have yet to determine a return to the office date while numerous others have announced that workers need not return to the office until 2021. Going into the pandemic, fundamentals in the office sector were strong with low vacancy rates and balanced new supply. The one-two punch of a global recession and pandemic-driven changes to the office's traditional role as primary workspace will undoubtedly force office users to rethink their space needs. While these factors will drive a reduction in the total amount of space required, social distancing guidelines will provide at least some counterbalance for office markets. Estimates suggest that up to 20% more space per employee will be needed in order to comply with recommendations put forth by the CDC. In addition, many workers have taken to the benefits of working from home and a recent Gallup poll reports that 59% of US adults would prefer to work from home at least part of the time. Hiring managers also believe the work-from-home trend will continue long after the pandemic subsides. Over 60% believe that either significantly more or somewhat more workers will remain home permanently.



Source: The Future of Remote Work, Adam Ozimek

Implications for Office Investors

What do these changes mean for office investors? In the near term, five- to ten-year lease terms help insulate landlords from the short term effects of the pandemic. However, longer-term attitudes of tenants toward appropriate social distancing and office usage is still unclear. There has been much talk about physical separation, increased ventilation and restructured office layouts. However, the reality is that most office buildings were designed and constructed with space efficiency as a primary objective. Re-engineering those spaces to conform to new tenant desires driven by health and wellness priorities will be challenging and expensive. Some landlords will be able to construct or re-configure their spaces into new-modern offices. These properties will be best positioned to command premium lease rates in the near term.

Most other building owners will do what is required to make office spaces safe but will lack the ability to completely transform them due to limitations created by the layout or age of the existing building systems. In any case, building owners will face additional expenses from cleaning, elevator and access point changes, and other reconfigurations. Although the office as we knew it will change, it will not go away as the spontaneity and creativity achieved by people coming together in groups cannot be perfectly replicated in a Zoom call.

Implications for Other Property Types

Other property types will also undergo substantial changes as attitudes toward cleanliness and social contact evolve. After 9-11, hotel occupancy took over two years to rebound to previous levels. The post-Covid recovery period looks to be similar, but only if an effective vaccine is developed by 2021. Retail assets, which were already in a prolonged decline, were delivered another blow during the shutdown phase. The logistical importance of industrial assets was amplified, and they will remain in high demand. Multifamily assets, normally considered the safest and most stable real estate assets, have been insulated from the initial economic shock. Government intervention in the form of significantly expanded unemployment benefits and direct payments to individuals has so far kept rent payments flowing. It seems clear that further support will be needed, or late payments, evictions and higher vacancy rates will follow.

ACG's Position

Of course all tenants want the safest and best space for their employees. But if only a small percentage of offices fit that criteria, where will the majority of office staff work? They will work in offices modified on a best-efforts basis to comply with pandemic-induced requirements. This will likely lead to an acceleration in the pre-Covid trend toward flexible office space. Companies increasingly want the optionality that comes with flexible space and will more easily envision a combined work-from-home and traditional office mix using this structure. In the near term, low-rise, non-urban-core office locations with good access to transit options will be in high demand and flexible office space in any location will benefit. If and when a vaccine becomes available, these areas will likely see a drop from the currently elevated demand levels. The pandemic created many unexpected situations for real estate investors. As the consequences work their way through the system, there will be many opportunities and pitfalls across property types. But investors should always remember that another unpredictable event, or an effective vaccine, could change or reverse current trends.

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