Reconsidering the State of Office

By Amy Wolff Sorter

Headlines heralding the office sector's doom have been common over the past several months. "The Next Crisis Will Start With Empty Office Buildings," proclaimed a June article in The Atlantic. "We Definitely Think the Office Sector is Crashing," a Fortune article noted. Also in July, Forbes predicted that "Demand for Office Space Could Fall 13% by 2030 – and That's Not the Severe Forecast."

Beginning in October 2023 and moving to the end of the year, Connect CRE contacted several office sector subject matter experts to determine whether the apocalyptic headlines were accurate. The takeaway was that, yes, the office sector is undergoing challenges. But what's being published doesn't delve into the nuances of this commercial real estate asset.

"Everyone jumped on the bandwagon that office is dead, but it ain't dead," remarked Citadel Partners' Co-Founder and Managing Partner Scott Morse. "It's transitioning and evolving."

Exploding the "Doom Loop"

One major negative factor attached to the office sector is the doom loop theory, which has also generated its share of headlines. Originated by Columbia University professor Stijn Van Nieuwerburgh, the doom loop follows this path:

- The increase in remote or hybrid work means fewer employees come into office buildings

- Fewer employees mean increasing office vacancies and decreasing leases and renewals

- A reduction in leases means more empty buildings and fewer customers frequenting restaurants and other central district businesses, forcing closures

- The combination of empty high-rises and shuttered storefronts means urban core ghost towns

- All of the above means less tax revenue and a cutback in city services, leading to crime in these CBDs

Here's the reality: The doom loop is a myth. At least it's not a reality right now. Employees ARE returning to work, even while the five-day office week is fast becoming a thing of the past.

"The pandemic showed employers that flex schedules can work and are appreciated by employees," said Aarica Mims, senior vice president and director of leasing with KDC. "But company culture and in-person collaboration are still key to a company's success. That involves bringing employees together, whether five or three days a week."

Speaking of which, is employee pushback still a thing? It depends on what's being read, but pushback seems to be ebbing. "Many of those who favor remote work also cite feeling lonelier

and more isolated," CREXi's Chief Operating Officer Eli Randel pointed out. "It's likely that people will increasingly return to the office, even through a hybrid arrangement."

The doom loop commentary also focuses on East and West Coast gateway cities. But not all CBDs are emptying of employees. For example, Chicago has indeed been struggling with volatile leasing. But Tony Russo, senior vice president – office with Lee & Associates, explained that leasing activity "bounced back considerably in the second quarter of 2023."

Meanwhile, in the south, Terra's CEO David Martin explained that "the South Florida office sector will continue to perform well and outperform the other major U.S. office markets." Many companies are coming to the state, even as "major corporations are generally requiring a return to the office," Martin said.

This is not to suggest that there isn't the potential for a doom loop. To avoid this scenario, landlords and building owners should stay current with what tenants want from their office space.

"The 'doom loop' mainly exists for those owners and property managements who continue to say 'this is how we've always done it,' and don't see the need for any change," said Mosaic Construction's Founder and Chief Marketing and Communications Officer Ira Singer.

Further west, MDL Group's President Hayim Mizrachi said Las Vegas has low office supply, steady demand, population growth and shorter commutes. All of this supports a favorable office market. "We can travel from north to south, east to west within 45 minutes. Most commutes are 15 to 20 minutes or less," he said.

Bifurcation – a Better Word

The problem with the gloom-and-doom office prognostication is that "office" is a huge sector. It encompasses everything from the older suburban Class B building to the Class AA trophy asset in the urban core.

Or, as Adam Showalter with Stream Realty Partners put it, the split between the "haves" and the "have nots." The "haves" are the well-located, newer buildings characterized by more demand and less supply. As such, that demand means less interest in "the lesser-located, non-trophy 'have-nots,'" said Showalter, who serves as Stream's Managing Director, Office Investor Services.

Because of this, the best way to describe the office sector is "bifurcation." The headlines focus on the older, less desirable product even as "Class A buildings are very sought after, particularly if they include a great amenities package," Mims said. Furthermore, "health and wellness-focused amenities, sustainability and energy-efficient building infrastructure and hospitality-driven services will continue to be key drivers as companies seek new office space," Martin added.

Also, don't count out the older office space.

Russo with Lee & Associates said that owners of Class B+ structures have upgraded their buildings in Chicago's suburban office market. At the same time, occupiers are moving toward smaller footprints "while still providing a setting that gets people into the office," he said. "I call it a 'flight to practicality.'"

Speaking of “well-located,” “you have mature buildings that possess dynamite locations and offer tremendous value for businesses,” Morse pointed out. He said employees also favor these buildings, which can mean a shorter office commute.

Debt Maturities are Real – But Not a Cause for Panic

According to a recent CommercialEdge report, the total U.S. office debt is $920 billion, with nearly $150 billion of mortgages set to mature by the end of 2024. Furthermore, more than $300 billion of mortgages should come due by the end of 2026.

The SMEs didn’t play down the office sector’s debt-maturity problems. Nor did they sugarcoat the office maturities issues.

“Properties are unable to meet LTV (loan-to-value) and DCR (debt-coverage ratio) requirements and require large cash infusions from sponsors,” said Adam Finkel, co-founder and managing partner of Tower Capital. Large office properties in Los Angeles and New York have already returned to lenders, while “there have been some Class A office properties trading at steep discounts,” he remarked.

Adding to the issue is that refinancing is no longer the sure thing to reduce maturing debt as it once was. “As loans are coming due, the increase in rates is going to be shocking to some landlords who may have secured a note at 4% but are now facing over 8% as the note expires,” observed KDC’s Mims.

But the debt situation isn’t impacting all office buildings in every city across the United States. “Those properties acquired five to seven years ago by prudent borrowers who have opportunities to extend their loans by one to two years should get through this downturn okay,” Morse pointed out.

Furthermore, “office properties that don’t have debt maturity issues are typically those that have strong fundamentals, such as low vacancy rates and long-term tenants with strong credit,” said Petra Durnin, head of market analytics with Raise Commercial Real Estate.

Nor will there be a sudden wave of foreclosures, with distressed office buildings hitting the market. “There’s so much more that is actually happening than rushing to the assumption that it’s going to be the Great Financial Crisis again, and all properties are going back to the banks,” Mizrachi pointed out.

One reason is that lenders are more willing to work with office borrowers today (versus circa 2009). Those who issue loans understand that they’re not property managers or building operators. “Many lenders may recognize that the operator is better suited to maximize collateral value and may seek to extend loans,” Randel said.

Additionally, “it’s challenging for lenders to divest those assets in today’s environment,” Finkel explained.

Landlords are Stepping Up

Another piece of good news is that landlords and ownership groups in charge of older office assets aren't sitting around and worrying about the tenants (or lack thereof). They're beefing up their holdings to generate tenants – and leases.

"We are seeing ownership that has invested multimillion dollars in infrastructure and amenities to reposition their assets," Citadel Partners' Morse said. "The ones that have done it well in a thoughtful way are seeing the returns on their investments."

The main upgrades include fitness centers, on-site food-and-beverage services and more efficient technology infrastructures. Adding coworking and meeting spaces, improved lobby spaces, and hospitality-related services (like concierge assistance) can also boost tenant appeal.

Durnin said that adding green spaces or vertical farming to office buildings can improve air quality while supporting urban agriculture needs. Furthermore, "buildings with modular interior designs that can be reconfigured could meet changing needs over time and reduce construction waste," she observed.

Putting the effort and capital into an older office asset also improves the optics. "They're showing the market that they are not only surviving but have cash to put into their buildings," Lee & Associates' Russo said. "This puts them at an advantage when competing for prospective tenants."

Potential Office Opportunities Abound

The current office environment offers opportunities for well-capitalized investors. "Entrepreneurial investors are likely to be presented with the opportunity to buy office for pennies on the dollar," commented Randel with CREXi. "The deals won't be easily financed and will require ingenuity and effort, but if office health stabilizes, fortunes may be made."

Even with today's questionable capital market, investors can tap into creative financing. Mims suggested that cash-heavy investors could partner with landlords with loans coming due but no money to pay them down. Additionally, "properties trading at a steep discount below replacement cost should be able to find bridge financing," Tower Capital's Finkel said.

Other potential opportunities focus on office-to-other conversions. There's also been a great deal of chatter that many office buildings don't lend themselves to new usages. But there have been some success stories in this situation. Under certain circumstances, offices can be converted to residential use. In other cases, office space can be kept as, well, office space. "We have advised several owners to use their vacancies as an advantage and position their properties for sale to owner-users," according to MDL Group's Mizrachi.

Singer with Mosaic Construction went one better, noting that building conversions aren't limited to residential uses, "but can find new life as schools or churches."

Gazing into the Crystal Ball

The experts said the office sector might be climbing out of "doom-and-gloom" territory in 2024, depending on how maturities are handled and assuming more employees return to work. Noted Randel: "We don't envision full recovery in 2024, but upward momentum and reversion back

toward the mean."

In discussing the outlook for 2024, the experts determined that:

Return to office will continue.

So will the need for hybrid workspace to meet the new office vision. Raise Commercial's Durnin added that the workspace will reflect the changing dynamic. "The hybrid workplace is becoming a permanent fixture synonymous with work styles that maximize efficiency and nurture creativity and innovation," she commented.

Also continuing? Flight to quality.

The demand for fully amenitized buildings will spill into 2024. This is the case "as businesses and tenants prioritize high-quality, amenity-rich spaces that enhance the overall work experience," Russo said.