

GLOBAL OFFICE ASSET TRENDS: A LOOK AT 2023 AND BEYOND

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Global Real Estate Alert

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Post-pandemic, with some level of remote work here to stay, the global real estate industry is tracking an unprecedented reassessment of the office asset class. To paraphrase Mark Twain, have the rumors of the “death of the office” been greatly exaggerated? Or are office assets hanging on, with a new focus lead by a “flight to quality” by end users? A rising rate environment makes navigating this new “normal” even more challenging. What trends are being seen in the global marketplace for office assets in response to these conditions for 2023 and beyond?

Globally there is a slow road to recovery in the office market lead by shifting needs from end users, with owners, investors, and lenders reevaluating strategies taking into account interest rate and valuation concerns. European city centers are holding valuations and rents, US and Australian markets are seeing a flight to quality and a glut of B- and C-quality office assets, which may be ripe for better uses. Disruption is in effect within the office asset class on a global scale, though this may ultimately provide opportunities for willing investors. Below we highlight trends and anecdotes across the United States, Australia, and several European markets in greater detail to shed further light on how developers and investors are coping with the stresses in diverse urban office markets.

OFFICE ASSET TRENDS IN THE UNITED STATES

Vornado Realty Trust's CEO, Steven Roth, declared recently in Crain's Business Daily, “you can assume that Friday is dead forever” and “Monday is touch and go.” While this may be an overly pessimistic viewpoint, major urban centers such as New York and Chicago are seeing some form of remote or hybrid working and shorter in-office weeks as a sticking trend. For major cities like New York and Chicago, large outlying suburban areas with high and costly commute times coupled with higher in-city living costs and larger numbers of jobs that may be performed remotely are disrupting urban office demand. In addition to shifting needs for in-office workspace, office tenants also are looking for newer, higher quality, amenity-laden spaces. Tenant and employee expectations have been disrupted by a “We-Workification” of office arguably just as much as in-office time expectations have been disrupted by the pandemic. Significant office space footprints are a waning trend for many major companies such as Google, Apple, and Facebook. Law firms, financial services firms, banks, tech companies, and the like are, globally, reevaluating their need for office space and reconsidering how their employees use the space they have. Owners and lenders are seeing, in the United States, losses in valuation on prime office properties in gateway cities as tenants roll over and downsize and as existing office stock ages.

- Trepp, the mortgage loan data-analytics provider, is currently tracking a “wall of maturities” in the commercial mortgage-backed securities market with a value of US\$12.7 billion expected to come due between 2023 and 2024 in Manhattan alone. Out of the US\$12.7 billion, US\$7 billion of this debt is

comprised of 10 office buildings, with four alone located on Park Avenue. Given the current rate environment and the valuation impacts, this will make refinancing difficult for equity owners.

- According to a recent Colliers market report, owners and investors will both need to navigate the changing sources of market demand, demographic trends, and lower occupancy rates, while also facing hesitation in the capital markets. Refinancing and modification requests should be treated with care, taking special consideration for potential equity needs in regards to dollars allocated both for asset refurbishment and capital improvements, as well as re-leasing costs.
- Colliers also expects over one billion square feet of office space to rollover before 2026. If, on average, tenants are seeking reductions of between 20% and 30% of their existing space, projections suggest upwards of 300 million or more square feet could be unoccupied as a result. Vacancy rates, together with other market conditions, are drivers in valuation reductions for office product across the board.
- Upside to the downturn? Significant valuation drops may result in interest from foreign and domestic equity buyers looking for fire-sale prices, depending upon their long-term hold strategies and appetite for repositioning.

Another trend to watch is a renewed interest in office-to-residential conversion. With today's increasing focus on environmental, social, and governance (ESG) and sustainability, more owners and developers are considering whether obsolete office assets are ripe for repurposing into different higher and best uses, specifically residential and multifamily housing. Recently, New York-based Silverstein Properties announced a capital raise for a projected US\$1.5 billion fund to focus on acquiring underutilized office buildings for residential conversion.

While conversion efforts can be extremely costly, with the right tax incentives and municipal or other local support, residential conversion may be attractive for B and C class buildings where existing design and construction attributes may lend themselves to alternative uses. Between 1995 and 2006, New York City's Financial District saw conversion of office to residential in approximately 13% of its previously existing office space through utilization by developers of New York's Rule 421-g, providing favorable tax incentives. Currently underway are plans by GFP Real Estate and Metro Loft to create New York City's largest ever office-to-residential conversion at 25 Water Street, the former Daily News and JP Morgan Chase offices, which contemplates the creation of as many as 1,300 new apartment units.

In order to further promote conversions in New York City, Mayor Eric Adams recently unveiled the New York City Office Adaptive Reuse Study, focusing on recommendations to facilitate "adaptive reuse" of underutilized office stock. The report includes proposals to ease regulations regarding conversion measures and proposes tax incentives to support affordable housing conversions. Notwithstanding renewed interest in adaptive reuse, some market watchers think the trend may ultimately be fringe at best. In an April 2022 Moody's Analytics report case study of New York conversions, the takeaway suggests that unless there is serious, permanent post-pandemic office valuation disruption, finding the right project for conversion may be a needle in an economic haystack.

Are offices shopping malls 2.0? Time will tell in the US market, but what is certain is that owners, investors, and lenders are reevaluating their approach to the office asset class across the board.

OFFICE ASSET TRENDS IN AUSTRALIA

Australia is experiencing many of the same trends in the office leasing market as that seen in the United States and Europe.

- Sydney is generally seeing resilience in office leasing among Grade A, or Class A, buildings. One result of the pandemic is a shift in how employers and workers seek to use their office space, desiring to have a collaborative, more social environment with appealing common areas.
- At the start of 2023, there was a 25% increase in tenant enquiries for Grade A buildings, however, many tenants are now renewing their leases and taking advantage of landlord incentives for fitout. One of the key drivers behind this is that it is increasingly difficult to lease contiguous floor space in Grade A buildings due to high occupancy rates.
- While the Grade A market is generally strong, B/C grade buildings are suffering and are not fully leased. There is evidence of a “flight to quality” as better quality office space becomes more affordable.
- However, notwithstanding this trend, the elevation of rental incentives combined with lower levels of occupancy is anticipated to have a material impact on valuations.
- As a result, large commercial office assets across the Australian eastern seaboard are currently facing a valuation dilemma. While listed property stocks have been trading at a heavily reduced rate over the past year, the direct market is yet to see corresponding discounts applied to the prices of office buildings.
- However, a number of key assets are expected to exchange prior to the end of the financial year in Australia and it is generally anticipated that they will be at a discount of 10–20% in comparison to 2022 valuations. Once the dust settles from these transactions, the optimistic view is that the deal rate will begin to pick up as parties adjust to the new valuation reality.
- There is also discussion as to whether the conversion of underutilized office assets is a viable method to address the nation's housing shortage. This may be an attractive option, however, it is not yet one that is supported by local policy. Recent changes in local political regimes may, however, boost interest in conversion or build-to-rent schemes.

OFFICE ASSET TRENDS IN EUROPE

The United Kingdom

Post-Pandemic Office Life

Similar to the trends noted above for the US, shorter workweeks still have a foothold in the United Kingdom. City of London workforce numbers on Mondays and Fridays pale in comparison to midweek where greater numbers of workers make their way in office. While Tuesday through Thursday numbers may not yet be at pre-pandemic occupancy levels, it is getting there. Weekly average office occupancy before the pandemic was 63%. The weekly average is now half of that at 31% but creeping upwards—on Tuesdays, Wednesdays, and Thursdays, the daily figure is now at 44% (two-thirds of pre-pandemic occupancy). There is a sense, however, that the in-office trend will continue slowly upwards as companies seek to capitalize on the value and necessity of in-person collaboration and training.

Leasing Trends

In focusing on “working smarter,” businesses want less space, better-quality space, and more-flexible space. Further, ESG concerns are also at top of mind. Evidencing these trends, we can look to simple numbers. So far this year, 92% of take-up by tenants in London is now of prime, or Class A, assets; 62% of take-up is of space that has an excellent or outstanding rating for sustainability; and 16% of take-up is by serviced office operators. Unlike in the United States and Australia, in London there is no glut of supply. Inflation in the construction industry, both with respect to materials and labor, has led to delay in new projects coming online. While it is projected that 16 million square feet of office space is expected to come to market over the next five years, average annual take-up (i.e., lease-up) is five million square feet, creating a shortfall. Further, while existing tenants may be reevaluating space needs, there remains demand with US tech and financial-services companies to expand to London. Rents are therefore stable, with an increasing gap between prime rents (edging up) and secondary assets (edging down). Luxury Class A space is in the region of £105 per square foot, prime £85 per square foot, and secondary is languishing at £40 per square foot.

Investment Trends

On the equity side, we are seeing a massive price correction in London. Capital values are 21% off of their June 2022 peak—the fastest drop the market has seen since 2008. In the span of nine months, approximately £210 billion of value was wiped off the books for UK assets.

Where is the Floor?

Where the valuation decline will stop is dependent on the stabilization of interest rates and reduction in inflation, both factors with great uncertainty in the short term. For purposes of defining metrics, keeping a close eye on 10-year bond yields is a useful factor. The 10-year yields are levelling off at 3.75%. If prime real estate yields are fast on their way to 5.25%, that reflects a spread of 1.5%, which is not so far off the 30-year historic average of 2% (compared with a spread of 3% over the years of ultra-low interest rates). On this basis, UK real estate may be beginning to look like it is on track for fair value. Q1 of 2023 has shown transaction volumes double those of Q4 2022, with much of the uptick attributable to renewed interest in offices by Asian buyers in particular. In March 2023, UK real estate showed the first positive returns since June 2022. London, which is facing its challenges, remains the second most popular market for Asian, US, and Middle East investors targeting Europe, and the third for European investors. Core office assets remain high on investors' wish lists. On this basis, the UK office market could turn a corner over the summer, to the extent that pricing and valuation may yet see a 25–30% decrease.

Germany

In principle, Germany is seeing the same trends in the office leasing market as in the United States, Australia, United Kingdom, and across Europe. Furthermore, the transaction market has come to a hold, to a very large extent. Expectations of vendors and investors continue to differ significantly and there is a general trend in the lending space to move towards conservative approaches and a general reluctance to finance new investments. In particular, developers in Germany have been reporting challenges in obtaining financing for new developments.

A number of current challenges to the office market have led to a significant downturn of turnover in rented spaces. According to a report by JLL Germany, the office market has suffered a 30% downturn in Berlin, Frankfurt, Munich, Hamburg, Cologne, Düsseldorf, and Stuttgart (the Big Seven) in Q1 2023. However, individual results differ significantly as Colliers Germany has reported an increase of 7% for Berlin.

The uncertainty in the market has also influenced the size of leases. The majority of lettings took place in the region below 800 square meters. Large-scale lettings, such as above 5,000 square meters, are becoming rarer. Notwithstanding the leasing size metrics, Class A rents remain stable and are even expected to increase given the scarcity of availability and increased desire for high-quality office products. This is shown by a vacancy rate of only approximately 4–5% for Class A space in the Big Seven.

- A lack of high-quality spaces in attractive locations is impacted by a number of factors including:
 - Property acquisition costs, which remain high;
 - General reluctance from financing sources to fund new developments, coupled with rising interest rates;
 - Unavailability of financing for projects with Russian investors (even if they are minority holders); and
 - Impact of price increases and supply chain issues within the construction industry.

Additionally, the German office market has seen a significant increase in the indexation of rents (i.e., consumer price index adjustments) of upwards of 10% in a relatively short time.

Further to the rent indexation issues, on the landlord side, pressure is being exerted as well in regards to the push for ESG. Germany in particular is seeking to formalize legal requirements wherein new buildings would need to include energy supply systems utilizing up to 65% renewable energy. As Germany further seeks to require replacement of existing building systems with environmentally friendly, carbon-saving initiatives in the near future, this is putting pressure on landlords to retrofit. Furthermore, the shift to remote work—together with a labor shortage causing employers to offer attractive working conditions in order to secure talent—means tenants and landlords alike are reevaluating their space needs and also reconsidering fit-out requirements. While demand for Class A space may be positively impacting rental rates, some tenants and employers are being cautious in regards to their lease take-up, and may consider lessening their existing footprints or subletting reserve space.

Italy

Leasing

Despite the disrupting effects of the pandemic and recent increases in rental rates in Milan and Rome, both 2022 and Q1 of 2023 have registered a positive trend for Italy's office market—arguably even above pre-pandemic levels seen in 2019, which was a record-setting year for office assets.

In terms of volume and numbers, 2022 saw a leasing uptake of about 520,000 square meters from occupiers, reflecting a year-over-year increase of approximately 35% against 2021. The most active business sectors in the office market have been finance, consulting, and fashion, which together absorbed more than half of the annual take-up in terms of square meters.

If it is true that the trend has been positive, it is also true that the typology of the investments in the office sector, especially for lease transactions, is changing.

Class A office rent levels, particularly in city centers, are at maximum prices. Milan prime rents stand at €650 up to €700 per square meter per year as a result of low vacancy levels and limited availability for desirable Class A space.

Similarly to what has been described in the other jurisdictions, remote and flexible working is becoming a reality for many companies, with most workers out of the office a minimum of one to two days per week. This reduction in in-office time has created a shifting need profile with prospective tenants. Occupiers active in certain sectors are seeking to relocate into smaller spaces nearer to the city center while at the same time seeking high-quality building standards, especially Leadership in Energy and Environmental Design certification or buildings compliant with ESG policies.

This shift has created tight market demand for Class A office products, which in Italy is not always easy to provide for. In city-center locations, many ancient buildings (which may be further subject to restrictions and constraints by the relevant municipal authorities, such as cultural or historical limits), may require a significant effort in terms of costs and timing to be converted into Class A products by owners and operators.

In the long term—in response to rent increases and taking into consideration today's inflation levels—as a practical matter, many occupiers are showing particular attention at lease negotiation to attempt to keep low the rent indexation and the common charges linked to their consumptions. Furthermore, the risks of the moment in connection with the costs and timing of the fit-out works make ready-to-use offices more attractive and competitive for occupiers.

Investment Outlook

Deal flow on the equity investment side in Italy is less robust than leasing uptake. In terms of deal numbers for 2022, 68 major transactions occurred, which is an increase from the prior year but is less vibrant than the leasing market. Given market uncertainty with respect to office assets, institutional investors are appearing more cautious in their deal making. Notwithstanding the foregoing, the Italian office sector nonetheless has been second, only behind logistics, in attracting investors totaling approximately €5 billion, with the greatest focus seen in Milan.

One of the main drivers of demand for quality office stock is the implementation of a new work philosophy focused on wellbeing and work-life balance. Occupiers are also now seeking offices with a new concept design, where common areas and co-living spaces are becoming essential to satisfy and accommodate the needs of the workers. Limited supply is keeping rental rates high, though overall investment demand is lower.

CONCLUSION

The office market across the globe is facing a slow road to recovery as owners, developers, tenants, and lenders all reevaluate their strategies and approaches to the office asset class. K&L Gates' diverse Real Estate practice is uniquely positioned to assist clients as they approach the new normal in office for 2023 and beyond.

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