



# The evolution of office investment opportunities

Nuveen Real Estate research highlights the opportunities in the U.S. office market, focusing on the factors likely to fuel outperformance.

Structural changes in the U.S. office market are transforming the investable office landscape and the way people use the space. The challenge for investors is to keep up with the evolving requirements of tenants. This means focusing on flexibility and meeting demands for sustainability and wellness. Our research identified the factors that are likely to drive outperformance in this market and the subsectors likely to deliver that outperformance.

## The factors driving outperformance

In our view, four factors will drive outperformance:

- 1. Location** — Offices will be in cities underpinned by robust demographics.
- 2. Modern** — This will reduce the amount of capital expenditure required to bring obsolete offices up to standard.
- 3. Flexibility** — Workforce demands are changing with co-working trends and expectations for more amenity-rich buildings.
- 4. Sustainability** — This encompasses energy efficiency as well as health and wellbeing criteria.

## Location — it's all about the people

In the United States, we identified 35 cities, which are known as Nuveen Real Estate's 'tomorrow's world cities.' We believe these cities are positioned to outperform the United States overall in the coming decades. This is due to their strong economic and demographic growth prospects, and their ability to innovate, while also providing residents a high quality of life.

Of these 35 'tomorrow's world cities,' we identified 21 cities best positioned specifically for office investment (Fig. 1).

Within the next decade, Generation Xers and baby boomers will begin to exit the labor force, while the youngest of

**Figure 1. Nuveen Real Estate office investment cities**

21 U.S. cities best positioned for office investments		
Atlanta	Los Angeles	Raleigh
Austin	Minneapolis	Salt Lake City
Boston	Nashville	San Diego
Charlotte	New York	San Francisco
Chicago	Oakland	San Jose
Dallas	Orange County	Seattle
Denver	Orlando	Washington DC

Source: Nuveen Real Estate, 2019

millennials and Generation Z will enter it. This demographic shift has significant implications for office investors, as this younger generation will transform office tenant demands.

## Modernity in the office sector

Capital expenditure as a percentage of net operating income relative to other sectors is significant in the office sector. In many gateway office markets, such as New York City and Washington, D.C., much of the office stock is obsolete. Landlords seeking to retain and attract tenants are being forced to redevelop and reposition their stock to adapt to demands for efficient and adaptable buildings.

It is hardly surprising these substantial upgrade costs are already being incorporated into the public markets, explaining the significant discounts to net asset value for office REITs. We expect significant capex will continue to be deployed across office portfolios in the near term, until the obsolete stock is transformed into the desired offices of tomorrow. Assets that have already completed that transformation and fit the target profile are likely to outperform their markets.

## Flexible offices are here to stay

Flexible office workspace is arguably a disruptive force for the sector. Flexible workspace refers to managed-office space, co-working centers and, more commonly, hybrid models of the two. In the current cycle, office tenants have demanded more co-working and flexible-office space options with shorter lease terms and highly amenitized space.

Employers are trying to improve productivity and attract talent with the right kind of workspace and location, while at the same time manage costs. Flexible office space offers these businesses a solution.

According to CBRE's 2018 Americas Occupier Survey, 85 percent of real estate executives plan to implement flexible-office solutions into their portfolio strategy. The top 10 flexible office markets account for more than 70 percent of the nation's flexible office space inventory. They also averaged 25 percent year-over-year growth in square feet.

A gap exists between what most office landlords currently provide and what corporations actually need. This creates an opportunity for investors.

The focus will be on flexible, cost-effective and amenity-rich buildings offering community space and internal areas dedicated to collaboration. Office space will migrate from a product to a service, and successful landlords will need to understand and manage this transition to remain competitive.

## Sustainable office buildings

Sustainability is a requirement for real estate investors. High-performing, energy-efficient and healthy buildings

reduce operating costs, but also enhance business productivity through occupant wellbeing. Getting it wrong can lead to negative impacts on real estate fundamentals, including void lengths, obsolescence, operational costs and liquidity.

Our analysis of NCREIF data indicates office buildings with higher ENERGY STAR® ratings have produced higher total returns since 2008. ENERGY STAR® is the government-backed symbol for energy efficiency, providing simple, credible and unbiased information that consumers and businesses rely on to make well-informed, cost-saving, energy-efficiency decisions.

All Nuveen Real Estate properties participate in our tomorrow's world sustainability program. This includes benchmarking energy performance in the ENERGY STAR® Portfolio Manager system, proactive monitoring of building performance, setting energy reduction targets, implementing low- or no-cost operational improvement measures and obtaining green-building certifications, where possible. As responsible investment managers, we are also committed to a 30 percent reduction in energy intensity by 2030 across our global real estate portfolio.

Within the office sector, we have established three core priorities to pursue during the next few years — health and wellness certifications, remote diagnostic technologies, and full adoption of LEDs.

Beyond energy performance and sustainability initiatives, we also assess the potential physical impacts of climate change on each individual office asset. Office acquisitions are vetted for exposure to climate change risk ranging from coastal flooding and severe storms to temperature extremes. Effectively managing buildings through a sustainability lens sits at the core of the investment process and business operations, forming a long-term view of real estate investment.

### Technology and the evolving role of the landlord

As well as helping offices become more sustainable, technology is also a key driver of user experience. As user demands become more sophisticated and customized, landlords are being pushed to become more of a real estate partner for tenants.

This requires specialist expertise, particularly in regard to technology. Through an innovation process of trialing new technologies, partnering with smart-building platforms, and localizing the application of technology to asset and tenant requirements, Nuveen Real Estate is able to monitor, evaluate and execute technological strategies with the aim of generating alpha and reducing obsolescence risk.

### Opportunities in the U.S. office market

Our research has identified two areas of potential outperformance and diversification for traditional office portfolios — the life sciences and medical office sectors.

Funding growth in the medical and biotechnology sectors, as well as overall healthcare demand, contribute to their appeal. Our analysis also shows both medical offices and life sciences have boasted stronger occupancy and lower levels of capex relative to traditional offices in recent years. As a result, these two sectors have higher risk-adjusted expected returns, with the spread premium to core property 60 basis points and 40 basis points for life sciences and medical offices, respectively (source: Greenstreet Advisors, Q3 2019).

There are many reasons to expect this to continue. The life sciences sector is benefiting from record-high research and development funding, a favorable regulatory environment, a strong R&D pipeline and technology advances from genetics to telemedicine. The shift from inpatient to outpatient visits and surgeries is likely to continue, supported by consolidation in the healthcare industry and demand from younger generations for convenience rather than committing to a primary physician. These factors will continue to support demand for medical offices.

### Outlook

We believe compelling investment opportunities can be found in the U.S. office market in modern, sustainability-focused office properties located in markets with strong demographic tailwinds. In our view, the life sciences and medical offices subsectors are likely to continue to generate alpha in a diversified office portfolio. However, numerous resilient office opportunities will be present for investors focused on investing in tomorrow's world cities.

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#### COMPANY PROFILE

**Nuveen Real Estate** is one of the largest investment managers in the world, with \$130 billion of assets under management. Managing a suite of funds and mandates, across both public and private investments, and spanning both debt and equity across diverse geographies and investment styles, we provide access to every aspect of real estate investing. With over 80 years of real estate investing experience and more than 600 employees located across over 25 cities throughout the United States, Europe and Asia Pacific, the platform offers unparalleled geographic reach, which is married with deep sector expertise. For further information, visit [nuveen.com/realestate](http://nuveen.com/realestate).

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