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Essential considerations and opportunities for today's U.S. office investors

Prior to the onset of COVID-19, the U.S. office sector was enjoying slow but steady growth. Office users fueled consecutive years of positive office space absorption from 2010 through 2019, and effective rent growth averaged 2.6 percent annually over roughly the same period.[1,2] While it remains too soon to determine the long-term impacts of the COVID-19 pandemic on the office sector, it's clear that the situation has challenged the sector like never before, and office users are reassessing how they use space and how much of it they will need in the future.

Amid the uncertainty, CIM believes that strong investment opportunities may soon present themselves to experienced, well-capitalized office investors. Sluggish population and job growth in major cities, like San Francisco and New York, may support timely office investments in smaller markets, and anticipated distress may create rare buying opportunities in certain primary markets. Additionally, specialized niches, such as life sciences real estate, may provide attractive opportunities.

Leading up to the pandemic, new technologies enabling remote work were beginning to eat away at office demand. Oversupply and a growing preference for city locations over suburbia exacerbated the situation. At the same time, companies began reducing the amount of office square footage allotted to individual employees. CIM expects the pandemic-driven downturn to put further pressure on conventional office properties. Notable concerns include the following:

» **Leverage —** Office assets with near-term loan maturities will need to resolve varying degrees of refinancing risk. Office owners that have maturing loans could face distress amid a lack of liquidity in the debt markets.

» **Co-working —** Co-working companies lease significant office space and re-lease it to businesses that need flexibility. But a general slowdown in leasing has adversely affected the companies and could have a negative impact on national occupancy.

» **Demand Reduction —** CIM has observed that a shift to work-from-home (WFH) practices, combined with job losses and rising unemployment due to COVID-19, is suppressing office demand in many markets across the country.

» **Increased Supply —** As a result of COVID-19 and economic uncertainty, the amount of sublease space available in the U.S. in the third quarter of 2020 grew to 124 million square feet, an amount that exceeded the previous record set following the bursting of the dot-com bubble.[3] Combined with vacant blocks of new supply, that increase was expected to push the national vacancy rate to as high as 18 percent by the end of the year.[4]

Considering these factors, CIM expects office investments in non-gateway markets, such as Austin, Denver, Phoenix, Nashville, Atlanta and Charlotte, to outperform those in many primary markets over the next three to five years. The relative low cost of living in these cities, access to quality education, low crime rates[5] and appealing climates were driving growth well before the pandemic hit, and migration into the markets is expected to accelerate. Rental rate growth in many small markets has outpaced the national average over the past few years: Over the 12 months ended Sept. 30, asking rents increased nearly 8.0 percent in Austin and Charlotte, 6.5 percent in Phoenix, and 4.2 percent in Atlanta.[6]

Amid COVID-19 and the WFH experiment, organizations have begun to consider distributing workers across geographies versus housing the majority of employees in high-rise office buildings located in dense and expensive urban markets.[7] Low-rise, loft and campus-oriented buildings with abundant affordable parking have become increasingly appealing to a new wave of tenants.

The anticipated migration into select non-gateway cities may continue a trend that has been ongoing for several years.[8] In the long run, however, CIM expects that cities will remain important and appealing centers of living, working and culture. CIM has observed that for roughly two decades, young adults

Life Sciences Sector

One of the immediate opportunities in major markets — and in select smaller markets — can be found in the life sciences sector. Properties containing lab and research space, generally considered an office asset niche, consistently reported less vacancy and better rent growth than traditional offices in the cycle leading up to the pandemic.[9] For the past three years, the assets have commanded lower capitalization rates than conventional office properties by as much as 150 basis points.

CIM anticipates that life sciences assets will continue to provide investors growth over the coming years for several reasons. The national life sciences market is still in the early stages of growth: Some 180 million square feet of existing inventory represents only 4 percent of total office inventory in the U.S.[10]

The aging Baby Boomer population was fueling investment in new medical tests, therapies and vaccines prior to COVID-19, and the virus has hastened the need for research to confront future medical challenges, big and small.[11] What's more, the dearth of fully built-out lab space discourages relocations. Life sciences inventory increased about 8 percent in 2019 over 2018, while rental rates grew roughly 6 percent and vacancy remained flat. Those reasons help justify a higher amount of capital needed to develop the specialized assets, which require generous ceiling heights of 15 feet or more to allow for ductwork, water lines and other critical infrastructure.[12]

and empty nesters who desired to live within walking distance of attractions helped drive revitalization in downtowns and other urban areas across the country. It took a global health crisis to thwart the momentum.

With vaccines and revised cleaning and security measures in place, CIM believes the general public eventually will return to high-rise buildings, mass transit, shared spaces and urban living. WFH also has long-term limitations. Some workers have reported struggling with distractions and feelings of isolation. Additionally, a virtual-only environment may cause significant challenges for new hires — especially recent college graduates — striving to adapt to their new roles and company culture.

Real asset investors must exercise caution and discipline when considering buying opportunities in the near term. Given the high valuations ascribed to centrally located assets prior to COVID-19, it may be challenging to find attractive traditional office investments in these larger, gateway markets. Additional economic stress could put further strain on tenants in the short run, which in turn could make it more difficult for landlords to maintain occupancy and cash flow. Eventually that could lead to distressed sales or recapitalization opportunities, especially for properties that are over-leveraged, face near-term lease rollover or lack leasing demand.

Assets with heavy co-working lease exposure present another potential opportunity. These properties may require significant capital investment if co-working operators substantially downsize or go out of business.

As tenants reevaluate their physical footprints and the potential permanent integration of WFH policies, these companies may place a heavy emphasis on employee safety and quality-of-life matters when deciding whether to expand, contract or relocate over the next three to five years. CIM believes that low cost of living and low taxes will increase demand for assets in growth-oriented, non-gateway markets. At the same time, CIM believes that experienced real asset investors may be able to position themselves for an eventual rebound in major gateway markets by taking advantage of buying opportunities caused by distress or other disruptions, such as an overhang of vacant co-working space.

CIM also believes that life sciences real estate could continue to be a strong performer over the near and medium terms. Solid fundamentals and a supply and demand imbalance may create opportunities for new development and the conversion of existing offices into labs in major life sciences hubs.

This article was excerpted from the recent CIM Group Market Insight on the office sector. Read the full article and find additional research at **cimgroup.com/insights.**

Footnotes: 1) JLL, *Office Outlook Q3 2020*, Oct. 14, 2020. 2) REIS, National Rent Growth Data, 2019. 3) JLL, *Office Outlook*. 4) JLL, *Office Outlook*. 5) *The Washington Post*, "The new boomtowns: Why more people are relocating to 'secondary' cities," Nov. 8, 2018. 6) Transwestern, *U.S. Market Office Outlook, Q3 2020*. 7) *The Wall Street Journal*, "San Francisco Office Rents Tumble and Show No Sign of Bottoming," Oct. 6, 2020. 8) Marcus & Millichap, *Beyond the Global Health Care Crisis, Summer 2020*. 9) Eastdil Secured, *Life Science Sector Primer, Second Quarter 2019*. 10) Eastdil Secured, *Life Sciences Overview 2020*. 11) JP Morgan Chase & Co., *Life Sciences in a Changing World: Startup Outlook Through 2020*, Aug. 21, 2020. 12) Bloomberg CityLab, *Here Comes the Life Sciences Land Rush*, Sept. 15, 2020.