REAL ESTATE

# The Future of Office: From Uncertainty to Opportunity

BARINGS INSIGHTS

There are three key drivers that will shape office demand in the recovery ahead—and ultimately determine which assets and markets will be the winners and which will be the losers.


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The U.S. office market started to show encouraging signs of stabilization during the second quarter of 2021 as many companies prepared to reopen their offices fully. However, one by one, companies are now announcing reopening delays due to the rampant spread of the Delta variant.

For over a year, the U.S. office market has been in a state of suspended animation as COVID-19 sent most office workers home. While the great disruption to the economy, everyday life and commercial real estate will likely eventually pass, we believe the office sector could endure the most profound long-term impact from COVID-19 among the five major property types, thanks to the forced, full-scale, work-from-home (WFH) experiment. Technologies and business processes have proven to be surprisingly ready to support remote work since the onset of the pandemic, and office workers appear to be enjoying their newfound work flexibility, with some seeking to keep at least some aspect of it in the future. Unsurprisingly, with these dynamics, we have seen far less consensus among real estate lenders and investors about future demand for office than any other property type.

In our opinion, broader adoption of remote work will be a net negative for office demand going forward, but the uncertainty and differentiated landscape will create opportunities for discerning investors. The accelerated adoption of remote work from the pandemic-induced WFH experiment has effectively compressed years of obsolescence into a span of about 18 months—and both companies and workers will increasingly have the ability to substitute technology for physical office settings. However, the top strategic priorities for most companies—growing earnings and attracting and retaining the best talent—are unlikely to be materially different post-pandemic. So, while earnings objectives increase the likelihood that companies will find a way to leverage technology to reduce their real estate costs, the intensifying war for talent will continue to make the office important—perhaps even more important—as a place for collaboration, cultivating corporate culture, training, mentoring, socialization and productivity.

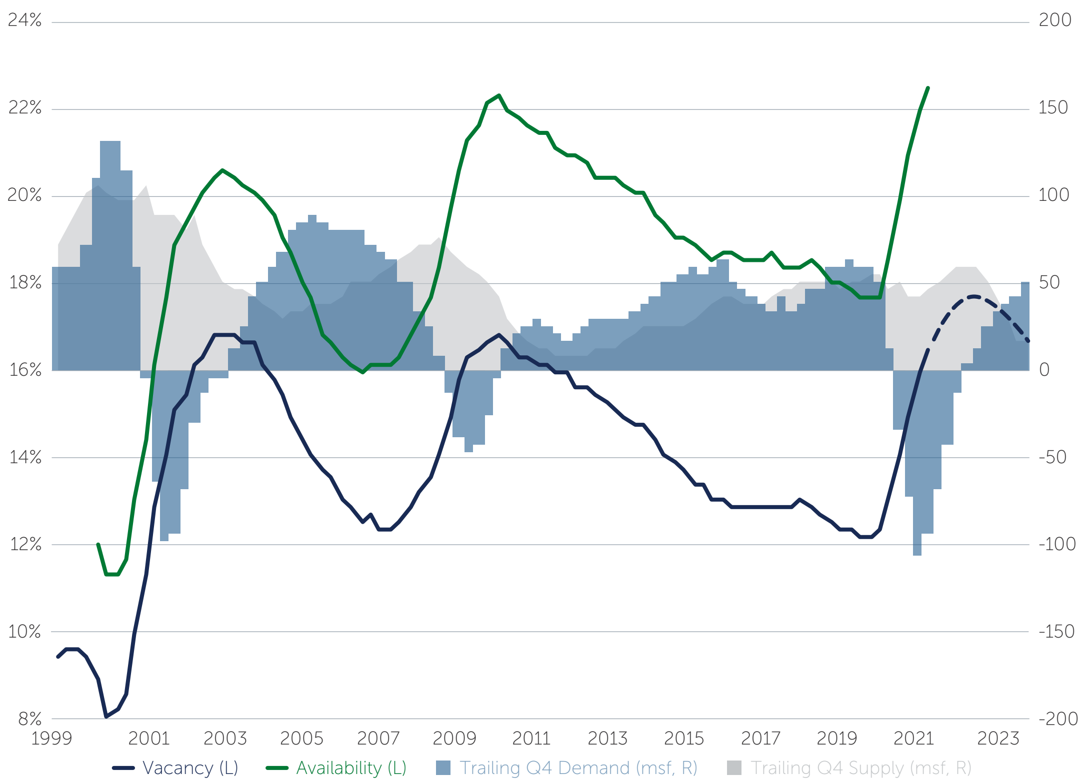
For investors with or seeking office exposure, three drivers will shape office demand in the recovery ahead and ultimately determine which assets will be winners, and which will be the losers:

1. The transition to a hybrid workplace
2. Employment growth in science, technology engineering and mathematics (STEM) and creative industries
3. The escalating war for talent

## Assessing the Damage

Widespread office closures, initially expected to last only a few months, have lingered on for much longer than anticipated, and as new coronavirus cases surge again across the U.S., hope for a full reopening in the fall of 2021 is quickly fading. The lockdown has taken a serious toll on U.S. office market fundamentals, and conditions in many markets may get worse before improving. The combined effects of a year and half with little or no new leasing, givebacks of space and a cyclical peak in new construction have created a perfect storm, driving vacancy rates to their highest levels in more than a decade. Office demand, as measured by net absorption, turned negative in the second quarter last year, and has since accumulated to nearly -116 million square feet (msf) through the second quarter of 2021[1], surpassing the total during the early 2000s dotcom downturn and more than twice the amount during the Global Financial Crisis (GFC). With supply continuing to deliver and not expected to peak until the first half of next year, the overall U.S. office availability rate, which includes occupied space available for sublease, has increased 500 basis points (bps) since year-end 2019 to 22.7%.[2]

**FIGURE 1:** Office Fundamentals Have Deteriorated Rapidly (U.S. Office Market)

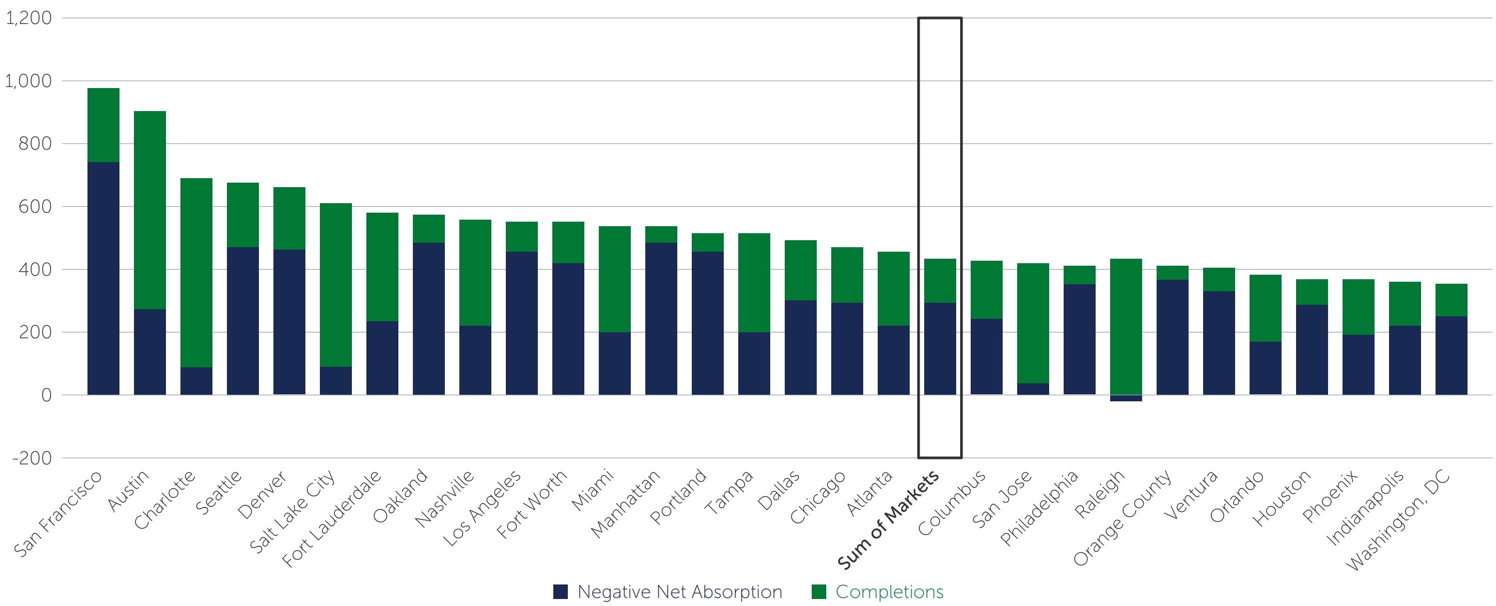



SOURCE: CBRE-EA (Oxford Economics forecast scenario). As of Q2 2021.

1, 2. Source: CBRE-EA. As of Q2 2021.

Performance has varied greatly by market due to different local supply/demand dynamics. Some markets—in particular, expensive major coastal urban centers—have been hit hard by space givebacks, while some leading growth markets such as Austin, Salt Lake City, Nashville and Charlotte are battling with elevated levels of new supply. Conditions also vary widely within individual markets. For example, while downtown Seattle has seen vacancy spike amid the pandemic, the Eastside submarket continues to maintain a sub-10% vacancy rate.[3]

**FIGURE 2:** Performance Has Varied Greatly Market to Market (Vacancy Increase Since 2020 Q2 by Market, bps)
*Contributions from Completions and Negative Net Absorption*




SOURCES: Barings Real Estate Research; CBRE-EA. As of Q2 2021.

## Uneven Recovery to a Bifurcated Future

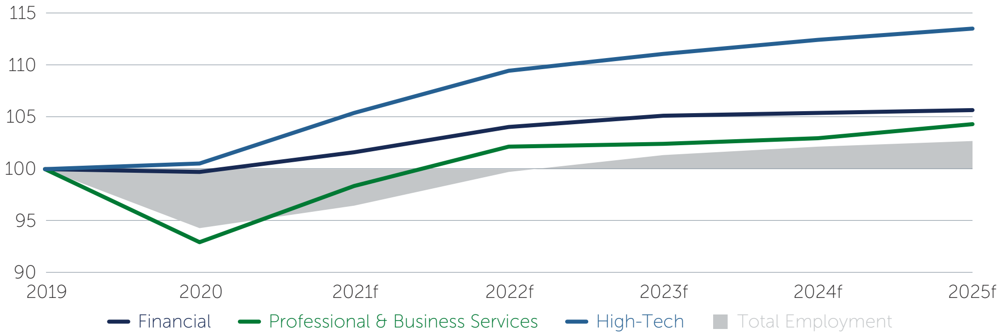
With corporate and individual preferences regarding future office use still evolving, it is especially difficult to model aggregate office demand, both short- and long-term, today. However, we believe a transition to a hybrid workplace is inevitable as office workers demand flexible work arrangements and companies invest in new and upgraded technologies to support remote work. Although the post-COVID remote work policies that have been announced so far vary widely, companies appear willing to accommodate their workers, and see remote work as a way to gain a broader reach to talent. While this may dampen aggregate demand for office space, the role of the office as a collaborating, training and socializing space—an environment that is difficult to replicate with today's technology—certainly has the potential to become more important, not less. This, in turn, should lead to rising demand for high-quality space, and in our opinion, may spawn purpose-built hybrid offices after the pandemic.

Also underpinning the expected strong demand for high-quality office space is growth in office-using employment combined with healthy corporate earnings. As the economy continues to evolve to a knowledge-based economy, office-using employment will capture a growing share of total job growth.

3. Source: Barings, CBRE-EA. As of Q2 2021.

As part of that process, with the ongoing digitization of the economy, the most dynamic growth will continue to be in high-tech and, more broadly, STEM sectors. From 2010-2019, high-tech employment expanded by about 3.5% per year, more than double the 1.4% growth rate for the labor market overall, and STEM sectors continued to add jobs in 2020.[4] Moody's Analytics forecasts high-tech employment will expand at a 1.5% annual rate over the next five years versus 1.2% for total employment **(FIGURE 3)**.

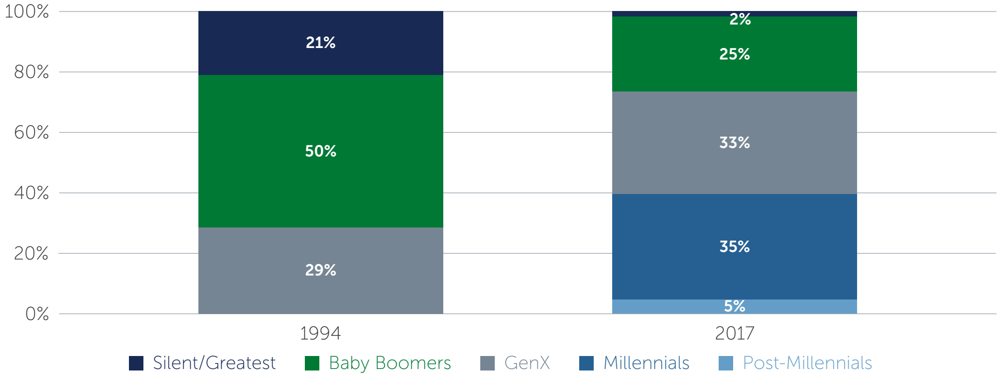
**FIGURE 3:** Tech Will Pace Employment Recovery (Employment Index by Sector, 2019 =100)




SOURCE: Moody's Analytics. As of May 2021.

The strong growth forecast provides a solid foundation for the office demand recovery, but it highlights the escalating war for talent, which will only intensify as working-age population growth slows and innovation becomes the key driver of the U.S. economy. The U.S. population is undergoing a generational handoff from the Baby Boomers (i.e., those born from 1946–1964), who for decades have dictated all things in the economy, culture and public policy, to Millennials (1981–1996), who now comprise the largest share of the U.S. labor force. For employers in knowledge-based sectors, especially highly competitive STEM fields, the ability to attract and retain well-educated Millennials will be paramount, and we believe the physical workplace and remote work policies will be important weapons in that effort.

**FIGURE 4:** Generational Handoff to Millennials (% of U.S. Labor Force)




SOURCE: Pew Research Center. As of 2018.

4. Source: Moody's Analytics. As of 2019.

Taken together, the transition to a hybrid workplace, growth in office-using employment and the escalating war for talent point to a bifurcated office recovery and future state that widens the gap between "space with a purpose" and generic, "commodity" space that faces increased competitive pressures from remote work. We believe the most competitive space going forward—or post-pandemic—will be specialized and/or highly amenitized space featuring state-of-the-art health and safety features and tech infrastructure, and the highest ESG credentials. While life science is an obvious example of specialized space that is and will continue experiencing robust demand, "creative" office space, which dominated office demand in the last expansion cycle, should regain momentum as workers return to the office and leasing picks back up. Transportation connectivity and walkability, the two most sought after amenities before COVID-19, are expected to remain important advantages after reopening despite some dense urban center markets being among the hardest hit by the pandemic. Commodity and class B space, on the other hand, faces significant headwinds from competition in many markets from the rising supply of new space and greater risk of disintermediation from remote work.

The bifurcation in performance will not be confined to just the quality of space. The aforementioned three forces will also drive a wide divergence in performance across markets. Investors should focus on markets benefiting from structural forces, namely demographics and STEM employment. Markets with a large and growing concentration of highly educated young people are likely to be the winners in this innovation economy.

## Closing Thoughts

We believe the pandemic will have a lasting impact on office occupier and worker behavior going forward. The WFH experiment has let the remote work genie out of the bottle, mostly by proving out technology that was widely available but underutilized before the pandemic. The wider adoption of remote work will likely render large segments of existing office stock less competitive and potentially subject to a higher risk premium for increased obsolescence and challenging leasing economics, at least for the near term. However, a bifurcated future offers opportunity for outperformance in a market of winners and losers. Lack of consensus/conviction should provide a window for savvy investors to acquire assets that will outperform over the next cycle. Not unlike what has transpired in the retail sector over the past 20 years, office assets that meet the new standards should attract robust demand, and command premium rents, as companies seek to leverage the office to cultivate corporate culture, enhance innovation and productivity, and compete for talent.

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