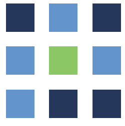

The Future of Office:
The Post-Pandemic Outlook for U.S. Office Investment

August 2021

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Executive Summary

THE FUTURE OF OFFICE: THE POST-PANDEMIC OUTLOOK FOR U.S. OFFICE INVESTMENT[1 2]

- The COVID-19 pandemic and efforts to combat it led to a severe decline in demand for office space in the United States in 2020. Market conditions have remained weak in 2021, but signs are apparent that a recovery is underway.

- Despite those encouraging signs, near-term prospects for the U.S. office sector are modest at best. Nationally, vacancy rates may not peak until early 2023 and rent growth is not forecast to gain significant momentum until later that year.

- The specter of remote working hangs over the office sector. The success of remote working during the pandemic is expected to lead to hybrid office environments in which some workers split time between the office and their home or another location close to their residence. Some market analysts have estimated that, as a result, future office demand may fall by 10% to 15%.[3]

- Remote working will be one of three key drivers of office demand in the coming years along with "de-densification" (the reversal of space-saving techniques employed in the last cycle) and growth in office-using jobs. We anticipate that the impacts of remote working and de-densification will largely offset one another at the macro level. Meanwhile, office employment is expected to fully recover its pandemic-related losses by the end of 2021, much more quickly than its rebound from the 2001 recession (four years) and the 2008-09 global financial crisis (six years).[4]

- At the local level, the impact of remote working will vary based on a metropolitan area's industry composition, the job functions of office workers and local office densities. Markets with a high share of remote-compatible occupations and above-average space per worker are likely to be at greatest risk.

- We believe that employers will continue to use office space to facilitate collaboration, camaraderie and productivity, as well as to promote mentorship and their corporate culture. In light of that ongoing demand, it is our view that modern buildings offering a fast, flexible and fun environment that entices workers to come to the office will ultimately win market share. Key trends to watch:

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1 This paper was prepared by Rockwood Capital in partnership with CoStar Advisory Services.

2 Information herein with respect to current and future real estate market conditions and trends reflects Rockwood's current belief and information from third-party sources that Rockwood believes to be reliable. Actual events or results may differ materially. There can be no assurance that historical trends will continue during the life of any Rockwood fund.

3 Green Street Advisors, "Office Insights: Whistle While You Work from Home," June 30, 2020; PwC and the Urban Land Institute, *Emerging Trends in Real Estate* 2021, October 2020.

4 Oxford Economics, United States Economic Forecast, Baseline Scenario data series, June 2021; CoStar Advisory Services.

  - Many tenants will have to maintain or add to their existing space in adapting their offices to accommodate the new hybrid working model.

  - Tenants will continue to strongly prefer modern, high-quality office product, particularly if they consider their space a showroom to entice employees to the office.

  - Building health and sustainability will remain a top tenant priority. Certified green buildings outperformed others in the years leading up to the pandemic—a trend we believe will continue.

  - The continued rapid growth of major technology and life-science companies will drive a significant amount of office-space demand, despite an anticipated increase in remote working by their employees.

  - Buildings leased to life-science tenants will serve as a hedge on traditional office investments. Increased funding for medical research, an aging population, and the need for most life-science work to be done on-site should create steady demand for space.

- Gateway markets could face a longer road to recovery than non-gateway and Sunbelt markets due to higher costs, a reliance on public transit and a preponderance of high-rise office product. Rents in several gateway markets fell dramatically in 2020 and may not fully recover for another one to four years. The rate of recovery will vary greatly by market and industry.

- The central business districts ("CBDs") of gateway markets, which were the most affected of any office segment, are likely to face considerable near-term challenges. Some tenant demand may shift to nearby suburbs, but we believe in the long-term appeal of higher-density, transit-served urban office settings and expect that gateway-market CBDs will eventually regain much of their former elite status.

- Key considerations for investors evaluating prospective geographic markets include labor-force and office-job growth as well as the educational attainment levels of local residents. Based on these factors, several non-gateway and Sunbelt markets are well-positioned for investment from a demand perspective, while several gateway markets retain various competitive advantages that should continue to make them attractive to office investors.

THE FUTURE OF OFFICE: THE POST-PANDEMIC OUTLOOK FOR U.S. OFFICE INVESTMENT

The outlook for the office property market in the United States remains opaque even as the pandemic that threw it into turmoil wanes and workers begin to return to their offices.

The specter of remote working, which proved so vital to the economy when health concerns essentially shut down the offices of most private corporations more than a year ago, now hangs over the office sector, with uncertainty greatest for downtown buildings in large, gateway markets.

At first blush, the adoption of remote working—and the hybrid in-office/at-home work weeks it is expected to spawn—should lead to a dramatic reduction in demand for office space, as fewer people commute to centralize offices and instead put in their hours at home or other remote locations. Estimates that overall office demand nationwide will fall by 10% to 15% over time have been bandied about for more than a year.[5] However, the logistics of accommodating hybrid two- or three-days-per-week office schedules, along with new office space layouts that require more space per worker, will likely counter much of the projected space reductions.

Still, the dislocation created by remote working will lead to winners and losers as tenant preferences evolve. Metropolitan areas heavily exposed to industries with a higher propensity for remote working are at greater risk, as are urban locations that require longer commutes, which could get even longer if more households settle in distant suburbs because they no longer trek to the office every workday. Regardless of location, we believe that modern buildings offering a fast, flexible and fun environment that entices workers to come to the office will ultimately win market share.

Current Market Conditions

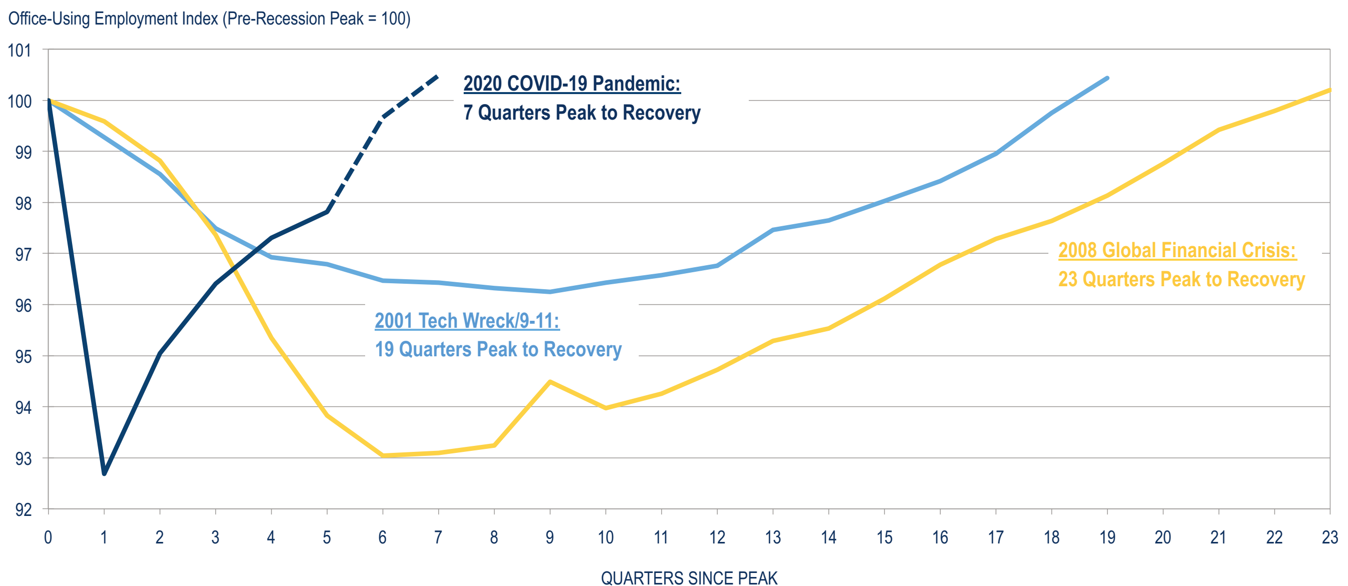
The pandemic's impact on the office market was initially modest. The industries most immediately affected were those that produce experiences (e.g., leisure and hospitality, some retail categories), since they naturally require physical proximity to others. Conversely, office-using sectors such as finance, law and technology were able to function remotely thanks to recent technological advances, most notably widespread high-speed internet access and videoconferencing.[6]

5 Green Street Advisors, "Office Insights: Whistle While You Work from Home," June 30, 2020; PwC and the Urban Land Institute, Emerging Trends in Real Estate 2021, October 2020.

6 Morris A. Davis, Andra C. Ghent and Jesse M. Gregory, "The Work-from-Home Technology Boon and its Consequences," National Bureau of Economic Research Working Paper No. 28461, April 2021.

In fact, remote working prevented a more severe employment decline in office-using sectors, as the digital economy was able to carry on despite the toll the pandemic was taking on the physical world. Office employment declined sharply in the spring of 2020 but rebounded solidly thereafter. As shown in Chart 1, through this past June, office-using sectors had regained 70% of the 2.6 million jobs that were eliminated a year earlier.[7]

Chart 1:
U.S. Office-Using Job Growth in COVID-19 Pandemic and Last Two Recessions



Sources: U.S. Department of Labor, Bureau of Labor Statistics; Oxford Economics; CoStar Advisory Services

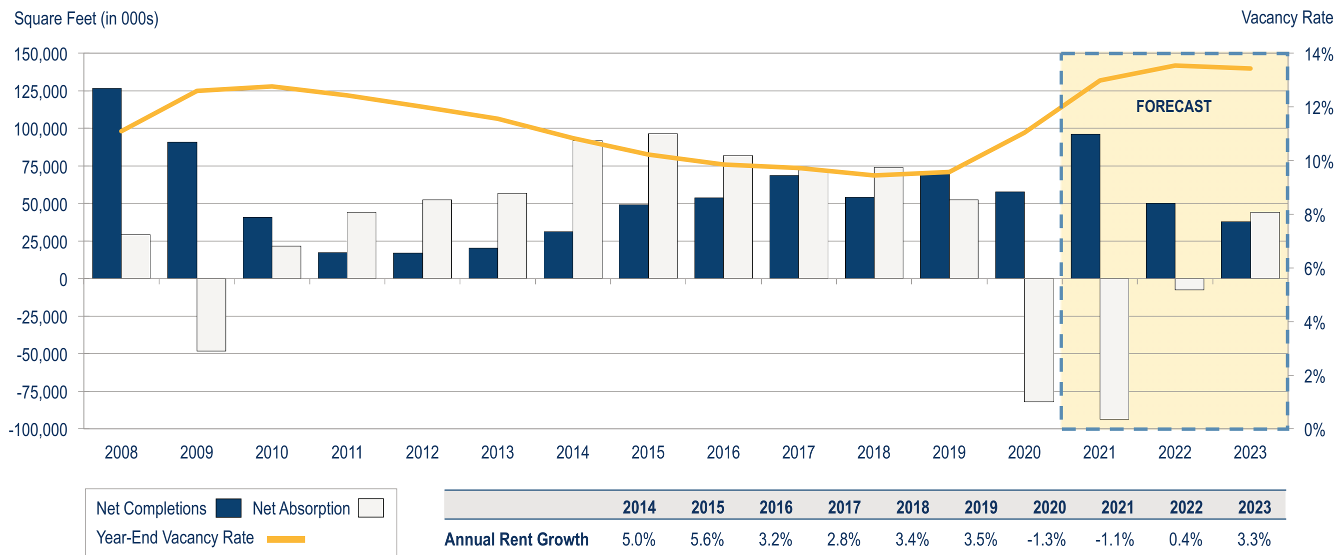
As the pandemic wore on, however, office landlords likely grew less concerned about the number of new office jobs and increasingly worried that those jobs might no longer be performed in their buildings, given the popularity and apparent productivity of this new way of working.

The pandemic and efforts to combat it led to a slump in net new office demand that was more severe than that triggered by the Global Financial Crisis (see Chart 2), as tenants postponed long-term leasing decisions and/or put millions of square feet of existing space on the sublease market. Within 54 major U.S. markets tracked by CoStar Group, vacancy rates jumped from 9.6% at the end of 2019 to 12.1% in second-quarter 2021, while asking rents fell by 1.5%.[8]

7 Oxford Economics, United States Economic Forecast, Baseline Scenario data series, June 2021.

8 CoStar Group, 2021-Q2 Real Estate Base-Case Forecast, Office Vacancy Rate and Market Rent data series, July 2021.

Chart 2:
U.S. Office Market Fundamentals (54-Market National Aggregate)



	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Annual Rent Growth	5.0%	5.6%	3.2%	2.8%	3.4%	3.5%	-1.3%	-1.1%	0.4%	3.3%

Sources: CoStar (2021-Q2 Real Estate Base Case Forecast)

Gateway markets such as San Francisco and New York were most adversely affected because of their higher costs, dependence on public transit (which most people avoided for fear of contracting COVID-19), and strict health-related regulations and reopening requirements. The central business districts ("CBDs") of these major markets—dominated by high-rise buildings that suddenly were difficult to access via elevators—generally experienced the steepest rent declines.

Although most indicators of office demand remained weak during the first half of 2021, there are early signs that a recovery is underway.

- Nationally, **office employment** is forecast to surpass its pre-pandemic peak by the end of 2021, thereby making a complete recovery in well under two years. It took four and six years, respectively, for office jobs to fully recover from the last two recessions, in 2001 and 2008-09.[9]

- **Leasing activity**, which dipped to 70% of its typical level in 2020, was at 75% of the norm in the first half of 2021,[10] Touring activity, generally considered a precursor to future leases, has also increased steadily of late.[11] Leasing activity should continue to improve during the second half of the year and into 2022 as pandemic-era restrictions are lifted and employees return to the office in higher numbers.

9 Oxford Economics, United States Economic Forecast, Baseline Scenario data series, June 2021; CoStar Advisory Services.

10 CoStar Advisory Services, July 2021.

11 *VTS Office Demand Index* (VODI), June 2021.

- **Sublease availability** remains elevated, with just over half of the 54 major markets tracked by CoStar seeing an increase in sublease space of at least 50% over the 12 months that ended in June. But the rate of increase has steadily decelerated, from a 22% quarter-to-quarter gain in third-quarter 2020 to a 3% increase in second-quarter 2021.[12]

- **Supply pressures** generally are moderate, with construction under way on roughly 2% of the existing inventory nationwide.[13] Over the past decade, new construction fell far short of levels reached in previous cycles. Pre-leasing has been relatively strong in recent years, with commitments in most local development pipelines exceeding 50% of the to-be-built stock.[14]

- **Transaction volumes** have yet to rebound after plunging in 2020 amid heightened uncertainty and significant logistical issues faced by prospective buyers. Just over $39 billion in office properties were sold in the first half of 2021, a marginal increase over sales made in the same period a year earlier, but roughly 75% of first-half levels in the three years before the pandemic.[15]

Despite these encouraging signs, near-term prospects for the office market generally are modest at best. Nationally, CoStar does not expect vacancy rates to peak until first-quarter 2023, when they will reach 13.6%, and then decline gradually in subsequent years. (By contrast, vacancy rates at the high point of the last cycle in 2010 were 12.9%.) Average rents should continue to decline over the next several quarters before beginning to rebound in late 2022. In several gateway markets, rents are unlikely to exceed their pre-pandemic peaks for another one to four years, whereas rents in non-gateway and Sunbelt markets that fared better during the pandemic (e.g., Phoenix, San Diego, Miami) are forecast to recover at a much swifter pace.[16]

Countervailing Forces Shaping Office Demand

With the pandemic subsiding, the future of remote working and its impact on the U.S. office market is coming into clearer focus. A consensus has formed among employers and employees that remote working during the pandemic was successful.[17] Widely available high-speed internet service, cloud-based networking and virtual meeting applications, such as Zoom, made working from home (or practically anywhere) possible for most office workers, who theoretically have been able to free up time spent commuting to achieve a more healthy work/life balance. (Reduced commuting also eases traffic congestion in major metro areas and generates environmental benefits.)

12 CoStar Advisory Services, July 2021.

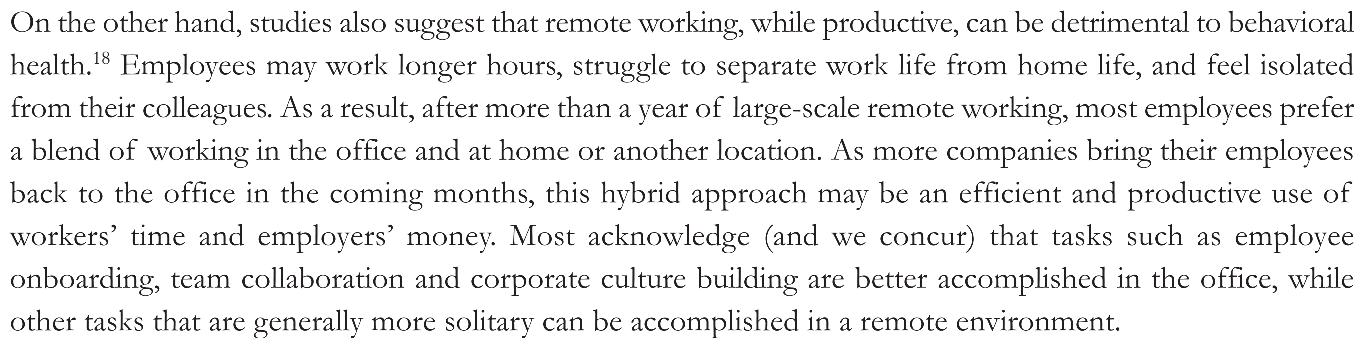
13 CoStar Group, 2021-Q2 Real Estate Base-Case Forecast, Office Space Under Construction data series, July 2021.

14 CoStar Group, Vacancy Rate for Completed Properties by Vintage Year data series, July 2021.

15 CoStar Group, 2021-Q2 Real Estate Base-Case Forecast, Total Transaction Volume data series, July 2021.

16 CoStar Group, 2021-Q2 Real Estate Base-Case Forecast, Office Vacancy Rate and Market Rent data series, July 2021.

17 PwC, "PwC Remote Worker Survey: It's Time to Reimagine Where and How Work Will Get Done," January 12, 2021.



On the other hand, studies also suggest that remote working, while productive, can be detrimental to behavioral health.[18] Employees may work longer hours, struggle to separate work life from home life, and feel isolated from their colleagues. As a result, after more than a year of large-scale remote working, most employees prefer a blend of working in the office and at home or another location. As more companies bring their employees back to the office in the coming months, this hybrid approach may be an efficient and productive use of workers' time and employers' money. Most acknowledge (and we concur) that tasks such as employee onboarding, team collaboration and corporate culture building are better accomplished in the office, while other tasks that are generally more solitary can be accomplished in a remote environment.

For example, 52% of U.S. office workers surveyed by design firm Gensler in 2020 preferred a hybrid office model in which they work one to four days per week in the office and the rest from their home or another location. Those workers considered the office the most effective place to collaborate with co-workers and stay up to date with their colleagues' work. Only 19% of those surveyed wanted to work remotely full-time and, perhaps surprisingly, 29% preferred to be in the office five days per week.[19]

A recent CBRE survey of office employers found that 87% plan to offer their workers permanent flexibility through hybrid arrangements that will allow both in-office and remote working.[20] That said, 85% of those same firms want employees to spend at least half of their work weeks in the office and thus do not expect to significantly shrink their office footprint. Fewer than 10% of the companies surveyed anticipate cutting their space by more than 30% over the next three years. Just over half of large companies (more than 10,000 employees) indicated they will make modest space reductions, while nearly three-quarters of mid-size (100 to 10,000 employees) and small firms expect to maintain their current footprint or increase the amount of space they own or lease.

In March 2021, Rockwood surveyed the tenants in the office buildings in which we have invested and found a similar pattern. Of the more than 200 survey respondents, 65% expected to implement hybrid remote/in-office working policies when they reopen their offices in the coming months, with a majority (54%) expecting that 80% or more of their employees would be working in the office a year after reopening. Another 35% anticipated that they would have 41% to 80% of their employees in the office a year later.

18 Frank Steemers, Robin Erickson, Gad Levanon and Rebecca L. Ray, *The Reimagined Workplace a Year Later: Human Capital Responses to the Covid-19 Pandemic*, The Conference Board, May 2021.

19 Gensler, *U.S. Workplace Survey: The Hybrid Future of Work*, Summer/Fall 2020.

20 CBRE, *Spring 2021 Office Occupier Sentiment Survey*, June 2021.

The adoption of remote working is one of three macro factors that will largely determine office demand in the coming years.[21] Each is highlighted below.

- **Remote Work**: Before the pandemic, just 6% of U.S. employees worked remotely on a regular basis.[22] In November 2020, 22% of all U.S. employees and 39% of workers aged 25 to 54 in professional and office occupations were working remotely.[23] Where the rate of remote working settles post-pandemic has enormous implications for future office demand. If that rate lies below 40%, or two days per week, it will effectively prevent employees from "working from anywhere," keeping most from migrating to other metro areas. However, migration within a metro area would be more likely, as many households may choose to live further away from the office if they are only commuting a few days per week. Metro areas that have a higher share of remote-compatible occupations and a higher concentration of remote-friendly industries, such as the technology sector, will likely see higher rates of remote working.

- **De-Densification**: Companies that intend to reconfigure their offices into "dynamic workspaces," flexible space plans that accommodate multiple tasks and work styles, such as quiet areas for focused work and open space for collaboration, may have to increase their office footprints, particularly if they adopted high-density, open floorplans or other space-saving techniques during the last cycle. On average, the amount of office square footage per worker at the pandemic's onset was at its lowest point in the nearly 30 years of data tracked by CoStar, having fallen by 19% since 1993.[24] Only 21% of U.S. office workers in Gensler's 2020 workplace survey worked in totally or mostly private office environments prior to the pandemic, but 47% preferred such workspaces when they return to the office.[25]

  Additionally, the difficulty office managers are likely to encounter in coordinating many different hybrid schedules will inevitably lead to lower efficiency. "Hoteling," in which unassigned desks must be reserved daily, was deeply unpopular with employees before the pandemic and is even less likely to be embraced today. Employees reporting to the office three or more days per week will continue to require dedicated space. Before accounting for remote working, markets with the densest office space will need to increase the square footage per worker to accommodate the same workforce moving forward.

21 Paul Leonard, "Winners and Losers in a Future of Lower Office Demand," CoStar Advisory Services, March 31, 2021.

22 U.S. Department of Commerce, Bureau of the Census, "United States Commuting at a Glance: American Community Survey (2006-2019) 1-Year Estimates, Worked from Home" (Table S0801), January 2021.

23 Gad Levanon, Elizabeth Crofoot and Frank Steemers, COVID-19's *Biggest Legacy: Remote Work and its Implications for the Post-Pandemic Labor Market in the U.S.*, The Conference Board, March 2021.

24 CoStar Advisory Services, July 2021.

25 Gensler, *U.S. Workplace Survey*, Summer/Fall 2020.

- **Job Growth**: Office-using job growth remains the most important driver of space demand. Regardless of how the future office evolves, metro areas with better job-growth prospects will see more demand for office space. U.S. office-using employment is expected to grow by a cumulative 6.9% over the next five years,[26] but growth will vary substantially by metro area. Among major markets, the office-using sectors in Houston, Nashville and Austin (fast-growing, Sunbelt markets) are projected to grow by 9.5% to 10%, while those in Philadelphia and Washington, D.C., (large, slower-growing markets) are expected to grow by 4% to 5%.

The countervailing forces of remote working and office de-densification will have enormous implications for office demand. Implementing social distancing floorplans can increase the average square footage per employee by almost 50%.[27] However, the rise in remote working is expected to prompt some companies to reduce their space, resulting in an estimated 10% to 15% decline in office demand.[28]

The sensitivity analysis in Chart 3 shows the impact of remote working and de-densification on demand over the next five years, assuming an 11.5% cumulative increase in office-using jobs over that period. Using a hypothetical estimate, if 5% of firms remained fully remote, 65% of firms returned to the office full-time, and the remaining 30% averaged a hybrid, three-days-per-week-in-the-office schedule, the effective remote working rate would be 17%. Office density would also need to fall by 17%—that is, the average square feet per worker would need to increase from 180 (the U.S. average as of early 2021) to 217—for the impact on demand to be net neutral after accounting for job gains.

Chart 3: Office Demand Sensitivity to Remote Working, Space Density and Job Growth

Demand Sensitivity Analysis, Next 5 Years		Office Density (SF Per Employee)				
		180 SF	200 SF	220 SF	240 SF	260 SF
Remote Workforce Effective Rate	10%	-4%	+7%	+18%	+28%	+39%
	20%	-15%	-5%	+4%	+14%	+23%
	30%	-25%	-17%	-9%	-0%	+8%
	40%	-36%	-29%	-22%	-15%	-7%
	50%	-47%	-41%	-35%	-29%	-23%

Note: The table factors in an 6.9% cumulative increase in office-using employment (defined as employment in the professional and business services, financial activities, information, and federal government sectors) in the U.S. over the next five years. The remote workforce effective rate represents a blended average of the daily remote rate for firms that are fully back in the office, fully remote, or some hybrid arrangement of both in-office and remote.
Sources: Oxford Economics, CoStar Advisory Services (Data as of July 2021)

26 Oxford Economics, United States Economic Forecast, Baseline Scenario data series, July 2021.

27 JLL, "How Will Employee Workspace Needs Change Post-Coronavirus?" June 19, 2020.

28 Green Street Advisors, "Office Insights: Whistle While You Work from Home," June 30, 2020; PwC and the Urban Land Institute, *Emerging Trends in Real Estate* 2021, October 2020.

As mentioned earlier, we anticipate that remote working's impact on office demand will vary based on the industry composition of a market's office tenants and the job functions of those tenants' employees. Chart 4 demonstrates that metro areas with the highest share of remote-compatible jobs tend to have the densest office space, which suggests that the two countervailing forces expected to affect space demand could offset one another in those markets.

San Francisco, for example, has the second-highest concentration of remote-compatible jobs (38.5%) of the metro areas featured in Chart 4, a level that, by itself, could threaten to erode office demand. However, its office density (152 square feet per worker) is also among the highest in the U.S., which should put pressure on tenants to expand or at least maintain their current footprint to allow for more space per worker in the office under a hybrid arrangement. A strong office-employment forecast over the next five years (9.2% cumulative growth) also suggests a growing need for office space.

Somewhat in contrast to San Francisco is Miami, which has a lower share of remote-compatible jobs (30.4%), but lower office density (177 square feet per worker) and a more moderate office-employment forecast (7.3%). Each market will have its own unique situation as we emerge from the pandemic.

Chart 4:
Office-Demand Drivers for Select U.S. Metro Areas

Market	Forecast Office-Using Employment Growth Over Next Five Years	Pre-Pandemic Sq. Ft. Per Worker in CBD	Share of Remote Compatible Occupations
Houston	10.5%	187 SF	28.7%
Nashville	9.6%	178 SF	24.2%
Austin	9.4%	151 SF	36.3%
San Francisco	9.2%	152 SF	38.5%
Los Angeles	9.2%	172 SF	31.8%
Seattle	8.8%	166 SF	36.0%
Phoenix	8.5%	161 SF	31.5%
Dallas - FW	8.3%	180 SF	31.1%
Charlotte	7.6%	180 SF	30.3%
Denver	7.5%	174 SF	35.5%
Miami	7.3%	177 SF	30.4%
Atlanta	6.9%	176 SF	33.0%
Portland	6.9%	179 SF	32.7%
Minneapolis	6.4%	185 SF	33.5%
New York	6.4%	170 SF	32.7%
San Diego	6.1%	185 SF	32.9%
Sacramento	6.0%	174 SF	33.3%
Tampa	6.0%	177 SF	31.6%
Raleigh	5.9%	171 SF	34.8%
Boston	5.8%	163 SF	37.4%
Chicago	5.0%	176 SF	31.7%
Salt Lake City	3.9%	202 SF	34.6%
Philadelphia	3.9%	173 SF	31.7%
Washington D.C.	3.5%	177 SF	43.3%
National Index	**6.9%**	**175 SF**	**31.4%**

Sources: Oxford Economics: Federal Reserve Bank of Dallas; O*Net; CoStar Advisory Services

Office Sector Trends to Watch

1. Office Design Will Evolve. Again.

As we noted earlier, the movement toward greater employee density over the past decade is almost certain to reverse in the coming years. Tenants will likely design or redesign office layouts to serve a higher propensity of remote working while creating an attractive environment for workers that also promotes health and wellness.

To encourage in-person visits, foster company culture and support productivity, tenants will look to improve the décor of their offices and add collaborative hubs, private offices and quiet spaces.[29] With social interaction and in-person connections with co-workers critical reasons for employees to be in the office, workplaces will foster engagement and collaboration ("we space"), yet also accommodate those needing private space for individualized tasks ("me space").[30] The hybrid office model will also require the workplace to have seamless office-to-home connectivity, and have the flexibility to house varying numbers of in-office workers.

Even before the pandemic, workers valued office design highly. Nine out of 10 office professionals surveyed by Capital One in 2019 believed they performed their jobs better in well-designed workspaces,[31] while millennial workers responding to a different survey considered office design to be the most important factor in the workplace.[32] In the emerging post-COVID office market, tenants increasingly desire flexible floor plans that can be readily adapted for different tasks. They also want their leases structured to enable them to quickly expand or contract their space.

Given these preferences, we believe that a dynamic office design that balances collaborative, private and other space to accommodate different tasks and work styles is clearly superior to single-purpose designs, whether they be fully open-plan or old-style offices/cubicles. The optimal mix of "we space" and "me space" will vary based on corporate culture and business/industry, but could include conference rooms, silent-work stations, networking zones, break rooms and private phone "booths." Space that can accommodate flexible and adaptive office layouts likely will be most in demand.

Health and wellness will be another important design consideration for office buildings. The presence of smart lighting, better thermal comfort,[33] indoor air quality monitoring, and anti-pathogen HVAC upgrades, as well as access to outdoor space can promote wellness and attract tenants. Safety can also be improved through desk configurations that reduce face-to-face orientation or by adding barriers in locations where forward projection is most likely.[34]

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29 "PwC Remote Worker Survey," January 12, 2021.

30 Stantec, *BlueSky Survey Executive Summary*, June 2021; Gensler, *Reconnect: Design Strategies for a Post-COVID World* (Design Forecast 2021), February 2021.

31 Capital One, "The Need for Adaptability in Workplace Design," August 19, 2019.

32 *Property EU*, "What Millennials Want from the Workplace," September 12, 2019.

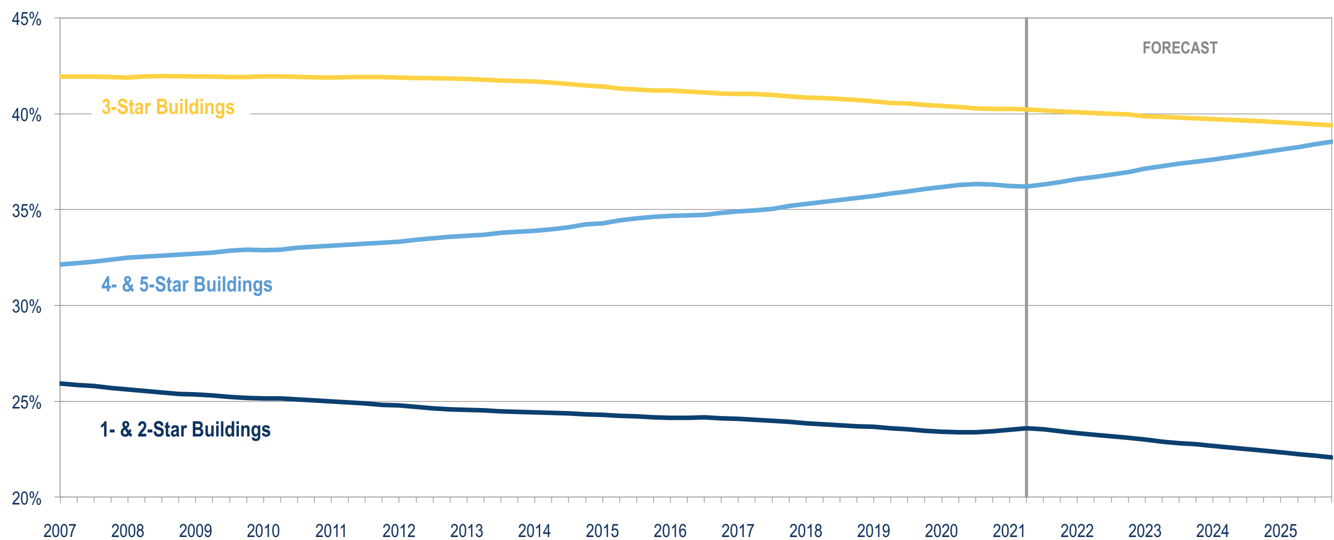
33 Judhajit Chakraborty and Kaitlyn Gillis, "How to Focus on Health and Wellness in Existing Buildings," Stantec, August 26, 2020.

34 Steelcase, "Four Macro Shifts Organizations Need to Address," *Steelcase 360 Global Report: Changing Expectations and the Future of Work*, January 2021.

2. Modern, High-Quality Office Product Will Continue to Gain Market Share

As they have over the past two decades, higher-quality properties should continue to gain market share. Prior to the pandemic, many tenants upgraded into higher-quality properties. In 2018 and 2019, office buildings rated four- and five-star on CoStar's scale of one to five accounted for 93% of all net space absorbed nationally, despite accounting for less than 40% of the overall inventory.[35] As shown in Chart 5, the highest-quality properties are expected to continue to gain market share, roughly equaling that held by three-star properties, which account for a much larger portion of the office stock.

Chart 5:
Share of Office Occupancy by Building Quality



Sources: CoStar (2021-Q2 Real Estate Base Case Forecast)

With health and wellness of vital concern as employees return to the office, the highest quality properties are best equipped to provide advanced features such as digital concierge, modern air filtration systems, smart elevators and touchless experiences. The cost of improvements such as these is often hard to justify for lower-quality properties, where rent levels are too low to offset expenditures.

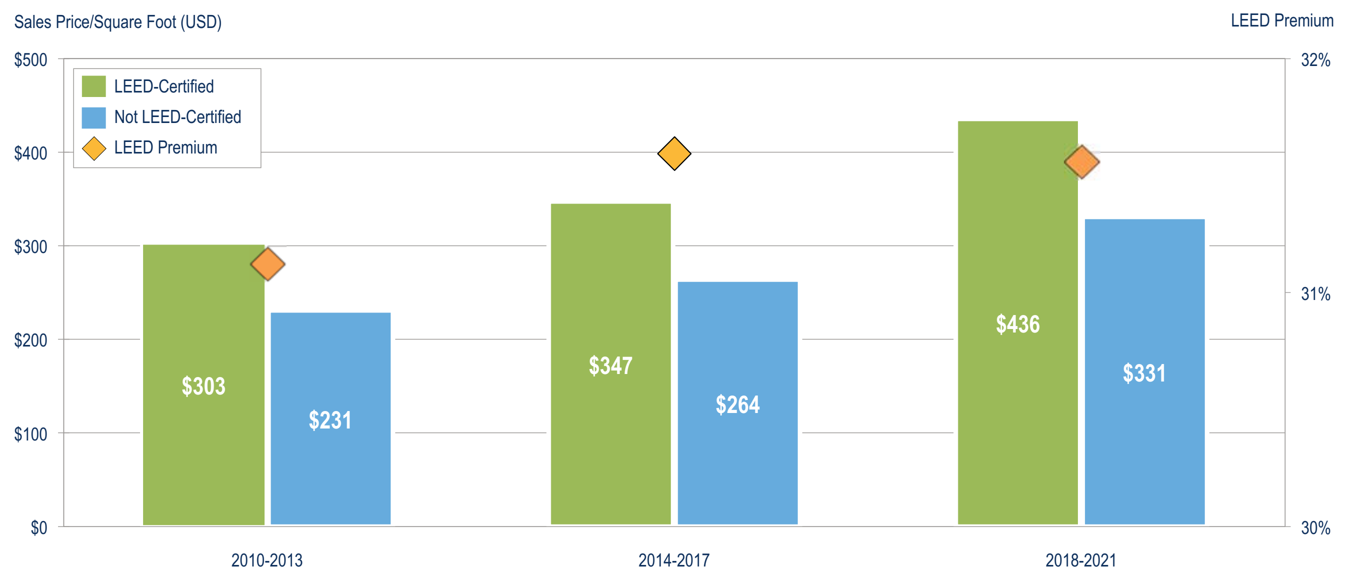
Looking beyond the pandemic, we believe that many companies will want to use their office space as a showroom to impress clients and entice workers to the office. Tenants may find they can invest more in state-of-the-art space because fewer workers are coming to the office daily and many back-office functions are performed remotely. Those seeking to reduce their office footprints are more likely to consolidate to their most strategic locations, which tend to be the highest-quality locations that are the most centrally located in the corporate portfolio. A reduced overall need for office space in the U.S. will put middling and lower-quality properties and locations at the most risk. The scarcity of space available at quality properties and locations will likely increase their premium in the coming years.

35 CoStar, 2021-Q1 Real Estate Base-Case Forecast Office Net Absorption data series, April 2021.

3. Building Health and Sustainability Will Remain Top Tenant Priorities

Municipalities, real estate investors and office tenants are expected to continue to focus on health and sustainability. Prior to the pandemic, many tenants—large and/or publicly traded companies in particular—were looking for space that improved their environmental, social and governance ("ESG") metrics. This trend led to the outperformance of green office buildings over the past decade.[36] As shown in Chart 6, so-called "green buildings," which we are defining as having achieved Leadership in Energy and Environmental Design ("LEED") certification by the U.S. Green Building Council, have achieved higher rents and sale prices relative to their peers dating back to 2010. That premium has increased in recent years. While asking rents in office buildings rated three stars or higher declined by 1.8% during the year that ended in March 2021, rents in similar-quality LEED-certified buildings showed a modest uptick of 0.4%.[37]

Chart 6:
Green Office Buildings Command a Substantial Premium



Source: CoStar Advisory Services (Covers 3-Star to 5-Star office properties in 54-market national aggregate)

Buildings that address tenant health and environmental concerns can also provide efficiencies and cost savings to owners, which can strengthen their long-term competitiveness and their performance in the investment market. Capitalization rates on LEED-certified property trades have trended 70 basis points lower on average than those of non-certified properties in the same geographies over the last 10 years, while the sales-price-per-square-foot premium commanded by those green buildings has averaged nearly 31% over the same period. Annual price growth for LEED-certified buildings, which represent just 10% of the U.S. office stock rated three stars or higher, has averaged 6.2% versus 4.7% for non-rated office properties of similar quality since 2010.[38]

36 Nancy Muscatello and Alexander Levy, "Green Office Buildings Report Even Bigger Rent, Sale Premiums During Pandemic," CoStar Advisory Services, May 12, 2021.

37 Ibid.

38 Ibid.

The growing awareness of ESG issues is giving real estate investors a greater appreciation of the inter-dependent relationship between buildings, the natural environment and public health. Rockwood, for instance, intends to continue to pursue investments that generate attractive financial returns, enhance the health and well-being of the local community, and reduce the impact on the natural environment. The firm recently produced two ESG-focused reports: "The Future Health of Our Cities: A Collaborative, Socially Responsible Framework for the Built Environment," in partnership with Gensler; and "The Future Health of Our Cities: The Nature of Value and the Value of Nature," a white paper authored by Neil H. Smith, one of the firm's founding partners.

More broadly, this heightened focus on ESG is expected to accelerate the shift to a more sustainable and energy-efficient office environment. Assets that are well-located and address concerns related to health and sustainability should continue to maintain, or even increase, their advantage in the coming years.

4. "Big-Tech" Companies Will Continue to Generate Significant Office Demand

Major technology companies, which were the largest aggregators of office space during the last decade, should continue to drive a significant amount of post-pandemic office demand.

Although employees of "big tech" companies such Apple and Google arguably are better suited for remote working than other office workers, the firms themselves are expected to grow more quickly than financial-services firms and other office occupants, and thus will continue to require additional space to accommodate their expansion plans.

The five largest tech companies by market capitalization — Facebook, Amazon, Apple, Microsoft and Google, which are often grouped under the acronym "FAAMG"— generally treat office space as an extension of their brand and corporate culture, using it as important recruitment and retention tool. Traditionally, they have located their campuses in Silicon Valley, San Francisco, Boston and Seattle, but have expanded in recent years to new markets (e.g., Austin, New York, Washington, D.C.), largely in search of new, highly skilled talent. All have announced their intention to bring employees back to the office, requiring most to work in the office two or more days per week.

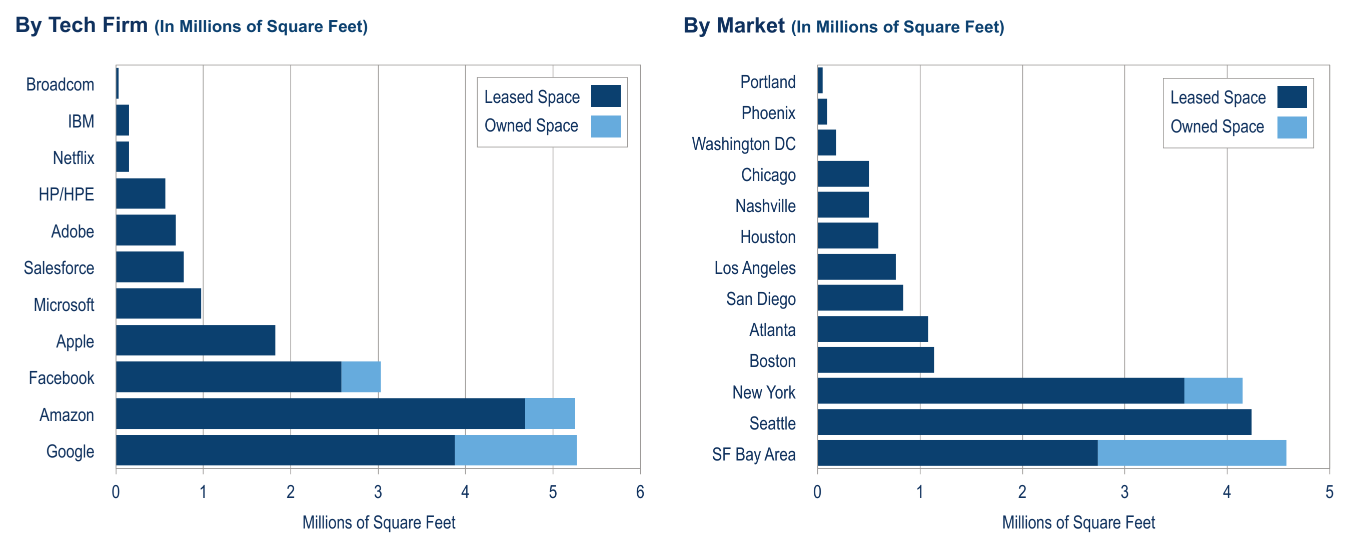
Since 2008, the five FAAMG companies have added a total of 73.5 million square feet of net new office space nationwide, led by Amazon (22 million square feet) and Google (19 million square feet). That number rises to 93.5 million square feet when the next 10 largest tech firms by market capitalization are included. In aggregate, these 15 big tech companies[39] have focused their leasing activity on the seven metro areas that CoStar considers to be gateway markets (Boston; Chicago; Los Angeles; New York; the San Francisco Bay Area; Seattle; and Washington, D.C.) and three non-gateway markets (Austin, Portland and San Diego). Beyond these 10 metro areas, however, the net space absorption of these 15 firms essentially has been flat.[40]

39 The 15 "big tech" companies that were analyzed were Amazon, Google, Apple, Facebook and Microsoft (together, the five FAAMG companies); Oracle, Salesforce, Intel, IBM, Samsung, Broadcom, Qualcomm, HP (including HPE), Netflix and Cisco.

40 CoStar Advisory Services, July 2021.

Looking forward, the 15 big tech companies should remain aggressive in occupying new office space. Nationally, they are planning to move into nearly 19 million square feet of space from mid-2021 through 2024, 85% of which will be leased, according to planned move-ins tracked by CoStar (see Chart 7). The 15 firms are planning on taking down more than four million square feet each in the Bay Area, Seattle and New York; and 500,000 to one million square feet each in seven other metro areas, including Boston, Atlanta, San Diego and Los Angeles.

Chart 7:
Known Future Move-Ins* by Big Tech Companies



*Future move-ins measure office space that will be occupied after June 30, 2021. A sampling of large technology firs was used in this analysis.
Source: CoStar Advisory Services

Other characteristics of these planned move-ins:

- 83% of the space is located in CoStar's seven gateway markets;
- 80% of the space is in urban submarkets; and
- 97% of the space is in higher-quality, four- and five-star buildings, as rated by CoStar.[41]

In addition, a little less than half of the space commitments by the five FAAMG firms were made after April 1, 2020, suggesting that these companies anticipate leasing or owning a considerable amount of space despite the expected uptick in remote working.[42]

41 Ibid.

42 Ibid.

5. Life-Science Properties Will Serve as a Hedge on Traditional Office Investments.

Office and laboratory space for the life-science industry, which we consider a subset of the office sector, has emerged as a popular investment niche, in part due to increased funding for medical research and an aging population that will live longer than previous generations and require advanced medical technologies and treatment. Additionally, many biotech, pharmaceutical and other laboratory functions require personnel to be on-site, making the space far less susceptible to the remote-working trend than traditional office buildings.

The life-science sector is a great example of an agglomeration economy that builds upon previous success and relies on a local ecosystem of existing employers, talented labor, business startups and venture capital. Only a dozen or so U.S. markets currently possess a meaningful life-science ecosystem, with three standing well above the rest: Boston, San Diego and the San Francisco Bay Area. Venture capital funding of health-care-related firms has grown threefold over the past five years to reach $31 billion in 2020, with nearly two-thirds directed to companies in California and Massachusetts, up from a little less than half of all such funding two decades ago.[43]

Other markets of interest include Raleigh/Durham, Seattle, the Washington, D.C./Baltimore corridor and, to a lesser degree, Philadelphia, New Jersey and New York—all of which receive above-average levels of funding from the National Institutes of Health on a per capita basis.[44]

Life-science rents in these markets have increased as much as twofold over the past decade and are approaching $100 per square foot in parts of the Boston metro area and $80 per square foot in the most expensive submarkets of the Bay Area.[45] Given rent levels and recent growth, it is not surprising that a considerable amount of new life-science space is now under construction, much of it in Boston and the Bay Area. Conversely, San Diego, Raleigh/Durham and Philadelphia have relatively little construction underway today and thus could offer more attractive investment opportunities.

5. Life-Science Properties Will Serve as a Hedge on Traditional Office Investments.

While all office markets were adversely affected by COVID-19, social distancing and government-mandated closures in 2020, large, gateway markets[46] saw the steepest decline in leasing activity and office utilization during the pandemic and have been the slowest to return to the office in 2021.[47]

Gateway markets share many characteristics that have contributed to this trend. Perhaps most significant are the generally long and mass-transit-dependent commutes for workers living in gateway markets. In all seven metro areas we consider to be gateway markets, at least one in 10 commuters uses public transit to travel to

43 PwC/CB Insights MoneyTree Report, Total U.S. Investments by Year, Q4 1994 to Q1 2021 data series, April 2021.

44 CoStar Advisory Services; National Institutes of Health, Fiscal-Year 2020 RePORTER Project Data; U.S. Census Bureau; Oxford Economics.

45 CBRE, U.S. Life Sciences Midyear 2021: Biotech Revolution Accelerates Demand for Lab Space, June 29, 2021.

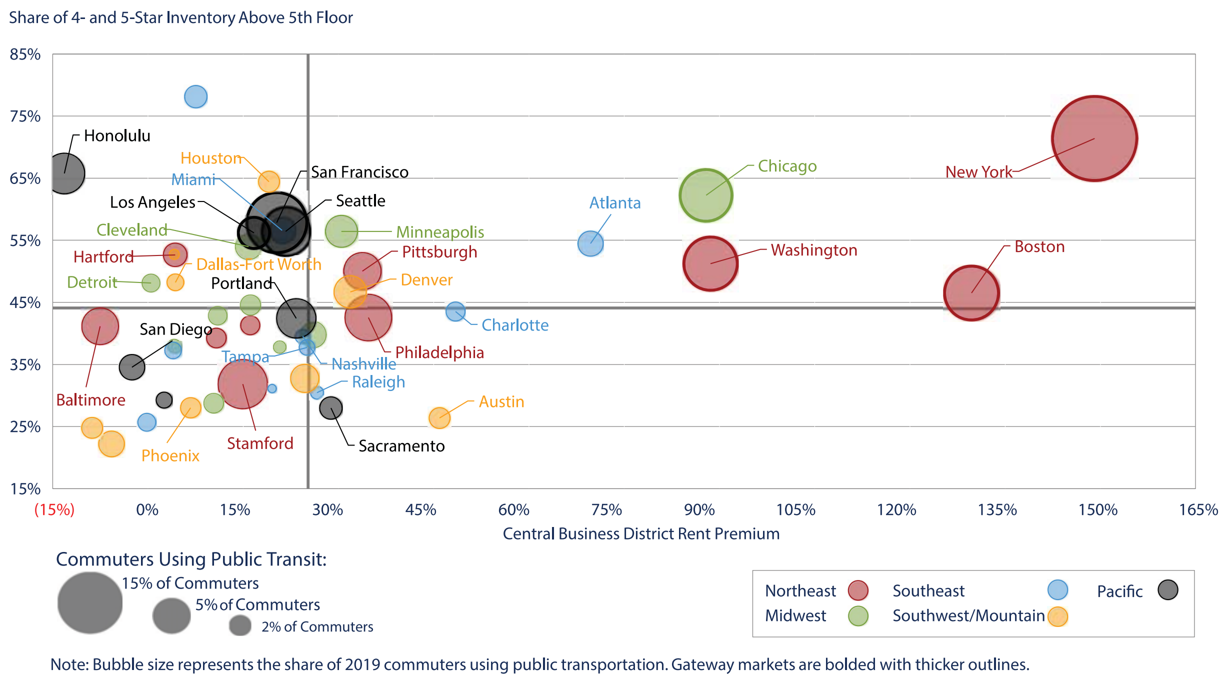
46 The following metropolitan areas are considered gateway markets: Boston; Chicago; Los Angeles; New York; the San Francisco Bay Area; Seattle; and Washington, D.C.

47 Kastle Systems, Kastle Back to Work Barometer: Weekly Occupancy Report from Kastle Access Control System Data, July 19, 2021.

work and ridership in January was down a staggering 66% to 80% compared to a year earlier.[48] Secondary and tertiary markets have also seen considerable declines in ridership, but most rely far less on public transit (well under 5% of commuters). Restoring both a safe and efficient commute thus will be a prerequisite for workers to return to offices in gateway markets.

Gateway markets also have among the highest rates of high-rise inventory and are home to the most expensive office rents in the U.S. Metro areas such as New York and Chicago have more than 60% of high-quality inventory on the upper floors.[49] As Chart 8 demonstrates, not all markets have to deal with these logistical problems. Most are heavily car-dependent and much of the high-quality office stock is on lower floors. Phoenix, Austin, Denver and Raleigh are examples of markets that are better positioned to bring a greater percentage of workers back to the office more quickly.

Chart 8: Gateway Markets Faced Unique but Temporary Pressures During the Pandemic



Note: Bubble size represents the share of 2019 commuters using public transportation. Gateway markets are bolded with thicker outlines.

Sources: U.S. Census Bureau, 2019 American Community Survey; CoStar Advisory Services(As of 2Q-2021)

In addition, gateway markets have suffered in recent years from a demographic one-two punch: a roughly 50% reduction in international immigration, which began in 2017 (under the previous presidential administration) and disproportionately affected New York, Chicago, Los Angeles and other major cities where

48 U.S. Department of Transportation, Federal Transit Administration, National Transit Database (NTD); U.S. Census Bureau, 2019 American Community Survey, 1-Year Estimates.

49 CoStar Advisory Services, July 2021.

immigrants tend to congregate; and an uptick in migration by domestic residents from large cities to less-expensive parts of the country. Starting in March 2020, the COVID-19 pandemic helped fuel additional out-migration, as a fair number of people who lived in CBDs of gateway markets opted to move mainly to nearby suburbs, but also to other lower-cost areas where they could afford larger living spaces.[50]

We expect this trend will reverse somewhat as more people head back to the office for many of the same reasons that have long attracted people to gateway markets (e.g., employment opportunities, cultural amenities, convenient public-transit service) and believe we are starting to see that play out as renter demand for our gateway apartment properties has strengthened of late. We also anticipate that gateway markets will greatly benefit from a return to more normal international migration levels as the pandemic impact lessens coupled with a loosening of federal immigration restrictions.

In the meantime, such markets are likely to face the most pressure from workers for flexibility, given that their residents typically have above-average earnings and educational attainment, the two biggest factors in determining future remote working arrangements.[51]

Of great importance will be whether the central business districts in gateway markets can maintain their rent premiums over the suburbs in the post-pandemic world. Office rents in CBDs of gateway markets were 88% higher than those in neighboring submarkets in second-quarter 2021; in secondary and tertiary markets, such premiums were 22% and 14%, respectively.[52]

It is ironic that the premier office markets in the U.S. at the onset of the pandemic—gateway market CBDs—appear to be the most challenged as that pandemic comes to a close. However, it is important to note that many of the pandemic's impacts are temporary in nature. Until recently, local governments in gateway markets strictly enforced office-occupancy restrictions. Public-transit commuting has been feared and, while this stigma is likely to linger longer than is rational, it too should subside in time, as will concerns over crowding in building lobbies and elevators.

CBDs have long been best positioned to serve as premier office locations because of their superior access to the local workforce via longstanding transportation infrastructure designed to efficiently move large numbers of people from their homes to a central office. Although some office demand in the coming years will likely shift from CBDs to the suburbs (first-ring suburban locations in particular), we believe in the long-term appeal of higher-density, transit-served CBDs and expect that, once offices reopen on a large scale and work routines are re-established, gateway-market CBDs eventually will regain much of their pre-COVID elite status.

50 Rockwood Capital, LLC, "U.S. Population & Migration Trends: A Closer Look," *2021 Real Estate Investment Strategy*, June 2021.

51 Jose Maria Barrero, Nicholas Bloom, Steven J. Davis, "Why Working from Home Will Stick, National Bureau of Economic Research Working Paper No. 28731, April 2021.

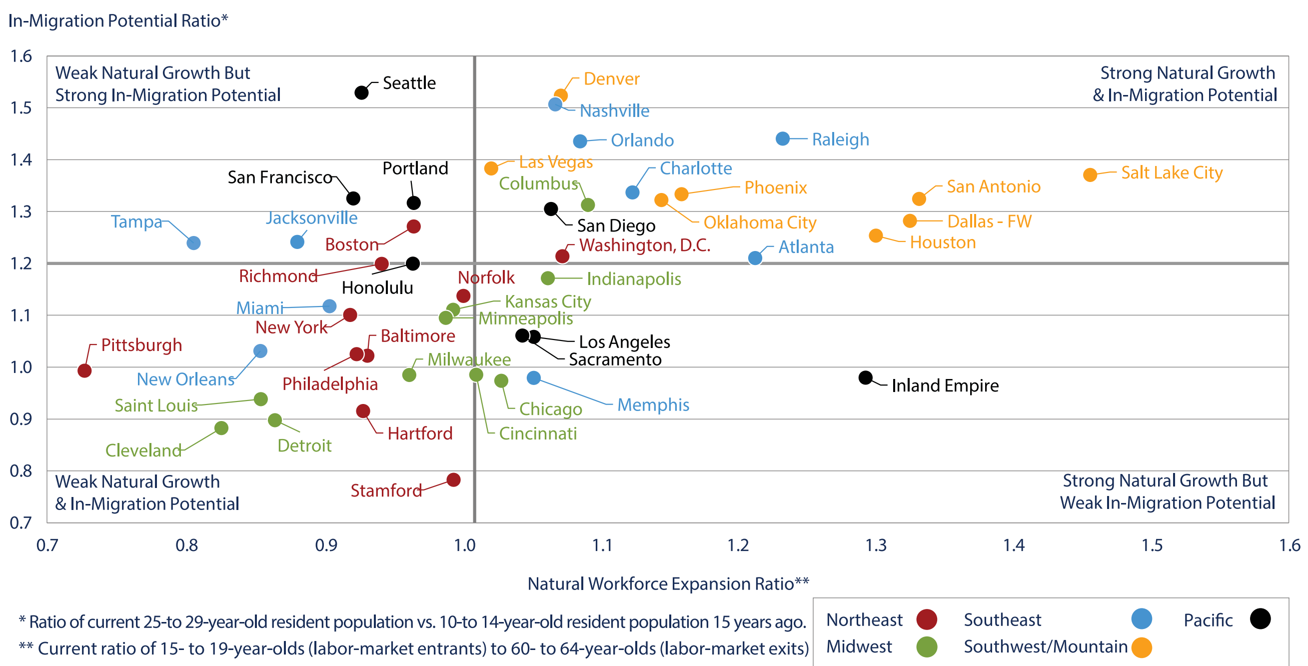
52 CoStar Group, 2021-Q2 Real Estate Base-Case Forecast, Office Market Rent data series, July 2021.

Identifying the Most Attractive Office Markets

At its core, a successful office market needs access to a qualified labor force, which starts with a large working-age population that will grow steadily through natural increase (resident births less deaths) and/or in-migration. To focus specifically on the potential growth of the labor force (a subset of the overall population) requires evaluating the size of specific age cohorts that either are entering or leaving their prime working years, which are typically considered to be 25 to 64 years of age.

In Chart 9, we plot potential labor-force growth for major U.S. metro areas as of first-quarter 2021. Growth via natural increase, based on the current ratio of the populations of 15- to 19-year-olds to 60- to 64-year-olds, is plotted on the X-axis. The Y-axis shows growth via in-migration, as expressed by a ratio of the current population of 25- to 29-year-olds compared to the population of 10- to 14-year-olds 15 years earlier. The U.S. average for each metric is represented by gray rules.

Chart 9:
Labor-Force Growth Potential of Major U.S. Metro Areas

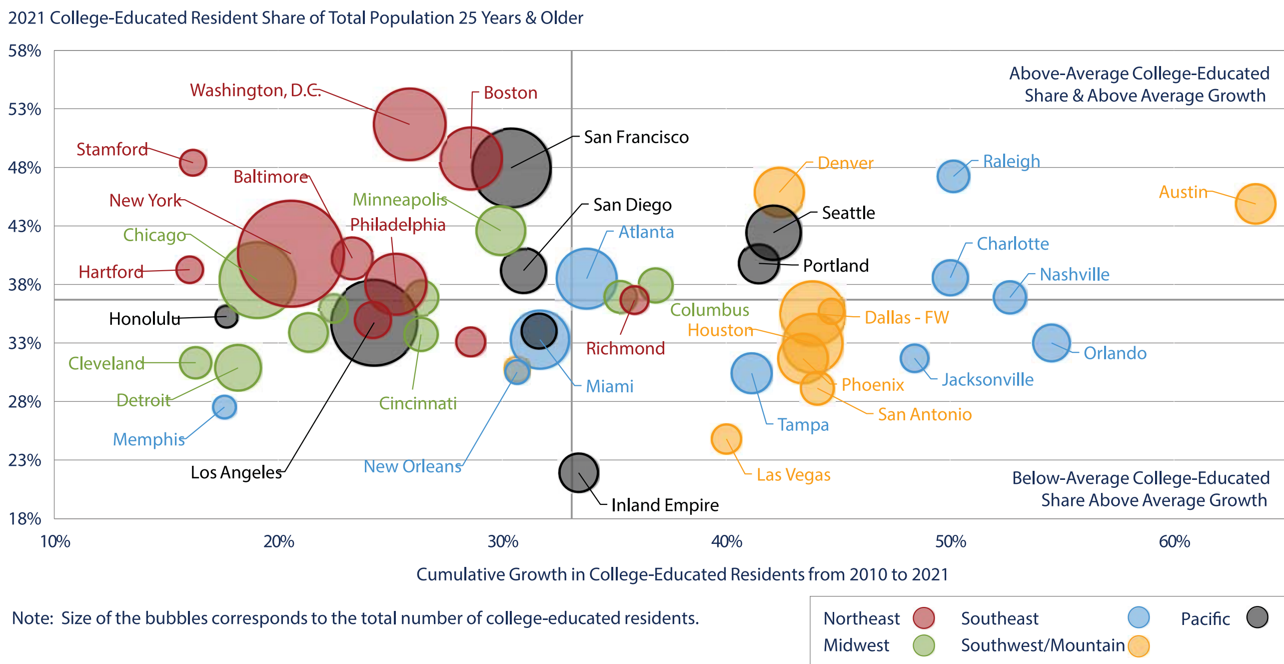


Sources: U.S. Census Bureau, Neustar; CoStar Advisory Services(As of 1Q-2021)

It is no surprise that leading metro areas in the fast-growing Southwest/Mountain West and Southeast regions have the potential to grow steadily through both in-migration and natural increase. As a result, many of the metro areas in those regions are situated in the upper-right quadrant of the chart. Most metro areas in the Pacific region are likely to achieve steady growth through either natural increase or in-migration; they are mainly plotted in the upper-left and lower-right quadrants. With a few exceptions (Boston, Columbus, Washington, D.C.), Northeast and Midwest metro areas have struggled to grow their workforces and are primarily located in the lower-left quadrant.

Educational attainment is a second key consideration for office investment after labor-force growth, as office-using occupations have a greater proportion of bachelor's and advanced degrees compared to other occupations. Chart 10 plots major U.S. metro areas by the current share of the population held by college-educated residents (Y-axis) and the cumulative growth of college-educated residents over the last 10 years (X-axis). All seven gateway markets have above-average educational attainment levels as well as far more people with college degrees than the non-gateway markets. Among the latter, Austin, Denver and Raleigh have some of the highest educational attainment levels in the U.S. Those three markets and others in the Southeast and Southwest/Mountain West regions have seen tremendous growth among highly educated residents, with some cohorts increasing by more than 40% over the past decade.

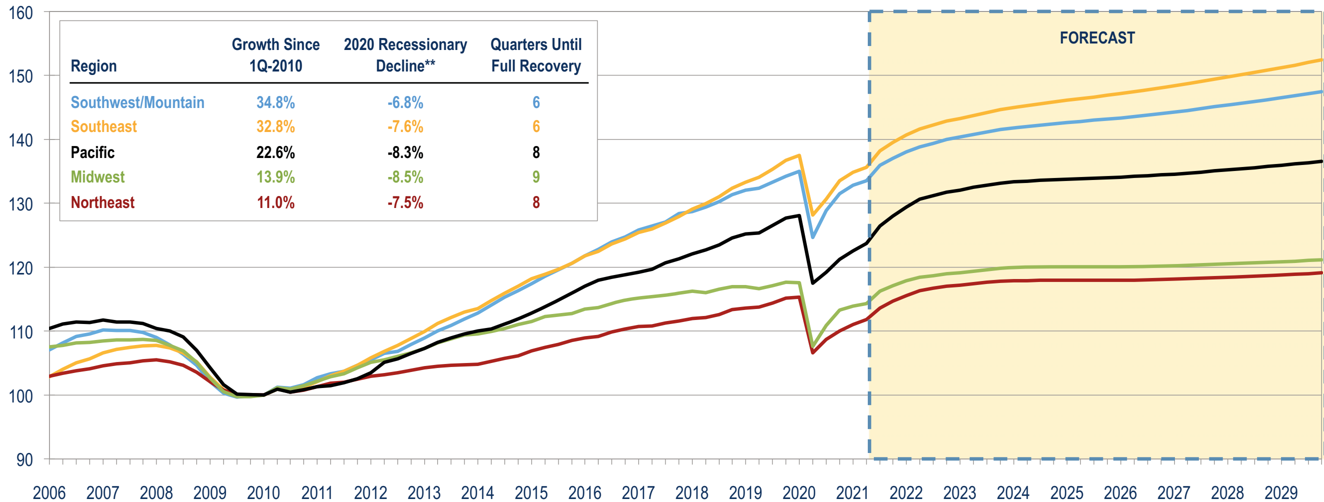
Chart 10:
Educational Attainment Levels and Growth of Major U.S. Metro Areas



Sources: U.S. Census Bureau, Neustar; CoStar Advisory Services(As of June 2021)

Growth in office-using jobs is a third major consideration in determining a market's office investment potential, if not an obvious one. Chart 11 shows historical and forecast growth in office-using jobs for the major U.S. geographic regions, indexed for comparison purposes. The Southwest/Mountain West and Southeast easily outpace the Midwest and Northeast, due to lower business and living costs and more favorable climates, with the Pacific region faring well in the middle ground.

Chart 11:
Indexed Office-Using Job Growth by Major U.S. Region



* Payroll jobs in the financial services, professional and business services, information and federal government sectors.
** Refers to peak-to-trough decline in employment in 2020 within 54 of the largest U.S. metropolitan areas, by geographic region.

Sources: U.S. Department of Labor, Bureau of Labor Statistics; Oxford Economics; CoStar Advisory Services (As of June 2021)

Gateway and Non-Gateway/Sunbelt Markets: Final Thoughts

As discussed above, Austin, Denver and other metro areas in the Sunbelt (i.e., the Southeast and Southwest/Mountain West regions analyzed above) appear to be fertile ground for office investment in the coming years, at least from a space-demand perspective. (Supply-side factors obviously could alter that prognosis.)

However, there are still pathways for office investments in large, gateway markets to succeed over the next decade. Gateway markets should continue to benefit from the agglomeration effects created by the clustering of technology and other knowledge industries in their cities and suburbs. Over the 12 months that ended in March 2021, 74% of the $167 billion in new venture-capital investments in the U.S. was directed to companies based in California, New York and Massachusetts,[53] which together are home to four of the seven U.S. gateway markets. The legacy of innovation and entrepreneurism in these markets, as well as the infrastructure and networks that support and nurture them, are a major reason why Boston, the San Francisco Bay Area and the other gateway markets should continue to flourish over the long term.

Technology, life-science, finance and other high value-add industries have developed robust clusters in these markets over many decades. Agglomeration economies are difficult to establish and are not easily abandoned. The virtuous circle of skilled labor meeting job opportunities, which in turn attracts more skilled labor, as well as capital, and then leads to additional job opportunities should continue to make gateway markets attractive to investors.

53 *PwC/CB Insights MoneyTree*, April 2021.

Conclusion

Although it may be cliché to call the past 18 months unprecedented, there really is no description that is more appropriate. Virtually overnight, most office workers in the U.S. and across the globe shifted to working remotely and most continue to do so, well over a year later. Gateway-market CBDs, long the premier locations for office investment, were largely abandoned during the pandemic and their prospects have been called into question.

But this too shall pass. A successful vaccination campaign began to bring a sense of normalcy to much of the country and employers have begun calling their employees back to the office, although the recent surge in COVID-19 cases driven by the highly contagious Delta variant may hinder plans. Ultimately, a chief legacy of the pandemic will be a permanent and potentially material increase in remote working that may temper demand for office space. New office layouts that likely require more square feet per worker to reflect increased demand for privacy and collaborative space should help counter lower office attendance and ease pressures to reduce tenants' office footprints.

Real estate investors looking to deploy capital in the office sector would be best served by focusing on acquiring and/or developing modern, high-quality buildings that promote wellness and are located in attractive mixed-use settings in urban and suburban areas. These assets will likely gain market share as older properties in weaker locations increasingly face obsolescence, particularly as big tech firms and other office tenants continue to prioritize employee health/wellness, environmental sustainability, collaboration, productivity and brand building. Properties designed for life-science industry tenants, a fast-growing niche within the office sector, have thrived over the past 18 months and should offer investors a unique hedge to traditional office buildings going forward.

In the coming years, the metro-area markets that are best positioned to outperform will be those that successfully attract and retain a highly educated and steadily growing labor force. Gateway markets will be challenged in their recovery because of their longer, transit-dependent commutes. However, they also have the benefit of well-established industry agglomerations that are not easy to replicate elsewhere. Sunbelt markets have an easier road to recovery given their lower population densities and car-dependent commutes. They also have grown much faster than gateway markets in recent years and there is little reason to believe that this trend will change over the next decade.

In our view, both gateway and Sunbelt markets can offer attractive acquisition and development opportunities for investors today, particularly for those who pursue a selective, rifle-shot approach that focuses on the quality of the submarket, location, tenancy and building design. There is not merely one way to outperform.

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