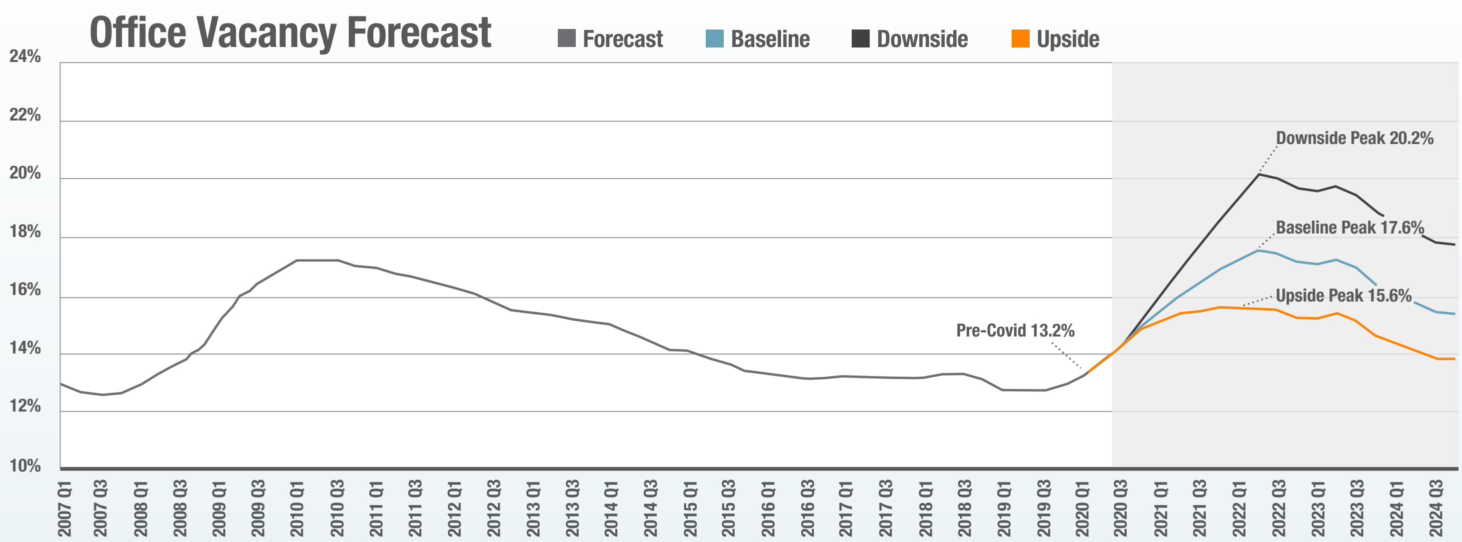
NOT SO NORMAL

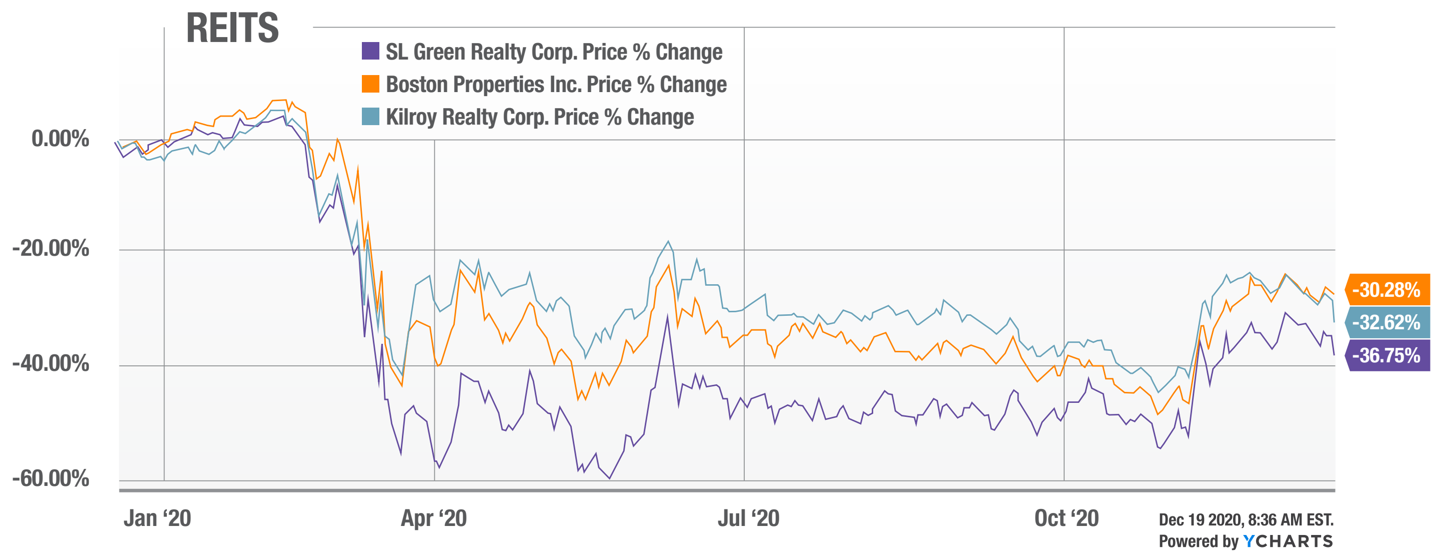
Photo by Kevin Bergen

I decided to focus my efforts this month on trying to figure out what is going to happen in the office market. This is a question that has both gotten a lot of media attention and been the subject, I'm sure, of many a private discussion. People across the world have had to adapt so quickly to the pandemic protocols of work-from-home and the virtual meeting. In my own experience, hardly a call goes by without the topic coming up. Some people love it. Some can tolerate it but maybe prefer being back in the office. And some just hate it.

We're at the very beginning of what I think is going to be a dramatic re-sizing of office demand.

As I got into my research, I quickly realized that something really profound was in the works. The establishment—i.e. large owners of office buildings and the brokers who make money selling and leasing them—acknowledge that a certain amount of pain and distress is inevitable as a result of the COVID crisis. At least they have the courage to admit that! They are essentially forecasting office vacancy to be about as bad as after the crash of the Internet Bubble, forecasting vacancy to rise from 13% to maybe 20%:





The market though is signaling something a bit more severe. The big office REITS down over 30% on the year. (chart above)

As I was digging into the question, I came across something that made me laugh. The establishment has been touting this (basically ludicrous) argument as to why we shouldn't be concerned about the future of office. For some reason, it reminds me of this scene at the very beginning of Gladiator where the Roman army is lined up waiting to see whether the barbarians would accept the surrender terms. When the barbarians instead send back a headless Roman on horseback, Quintus turns to Maximus and says something like "People should know when they are conquered." And then Maximus, in turn, replies "Would you Quintus? Would I?"

Anyway, the argument is something like this: one of the trends of the pre-COVID office world was increasing densification. Essentially, companies were responding to the inflationary pressures in the market (which, by the way, were caused by QE) by putting more and more employees into smaller and smaller spaces. This was true not just in the co-working and flex-space world but also in traditional office settings. What the establishment is saying now is that we should be bullish on office because this trend is going to be completely reversed as a result of COVID. "No, companies aren't going to shrink their office footprints as a result of COVID. They are actually going to need more space to provide safer, more spread-out working environments."

Yeah…

There's a lot of reasons why this is a ludicrous argument. Here's just one: companies are generally in the business of trying to maximize profits. Why take on more space when the whole world just learned that you can run massive multi-national enterprises (in some cases, more productively) from home?

Not surprisingly, left and right companies are announcing permanent work from home policies, walking away from planned real estate expansions and abandoning leases. For a while I was keeping a list of these announcements in my notes but as it grew and grew and I started running out of space on the page I just had to accept the disaster for what it was. I came across this site keeping track of all these announcements. I'm not sure how accurate it is or how comprehensive but what struck me as I was clicking through the list is the gravity of the situation. There are almost 2,000 companies on this list!

I really have to question the idea that things are just going to return to normal in the office world when this is all over.

Pew Research Center and the University of Chicago's Becker Friedman Institute did a big survey recently and found that as much as 20%-25% of workdays will be completed from home in the post-COVID world. I'm not sure exactly how this translates into reduced demand for office but it cannot be good.

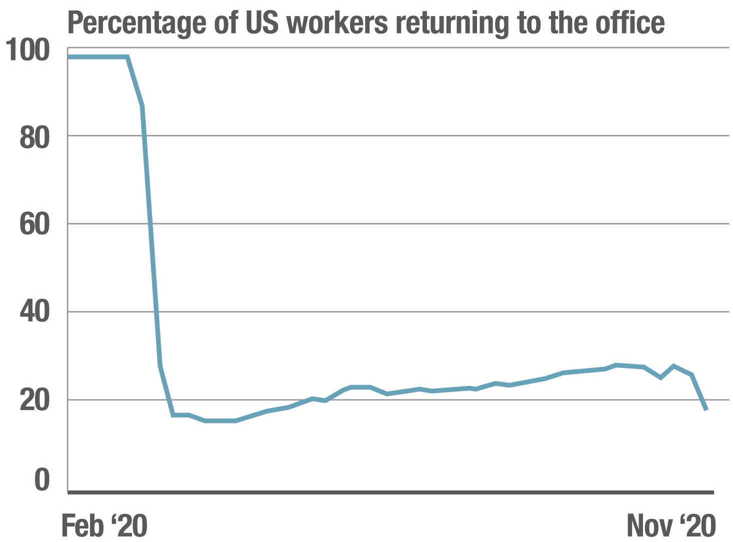
I don't want to be too flippantly pessimistic here. There are some data points on the other side of this argument:

For instance, Boston Properties' CEO recently noted in an interview on the Walker Webcast that in Shanghai and Beijing they are already seeing office occupancy at 95%. That doesn't seem like much change at all!

Interestingly, in New York, one of the hardest hit places in the whole world really, the funding (miraculously) came together for a new $2.3B, 1.4Msf office tower on Madison Avenue. And over the summer there were also reports that some big tech companies signed leases for substantial new space in the city.

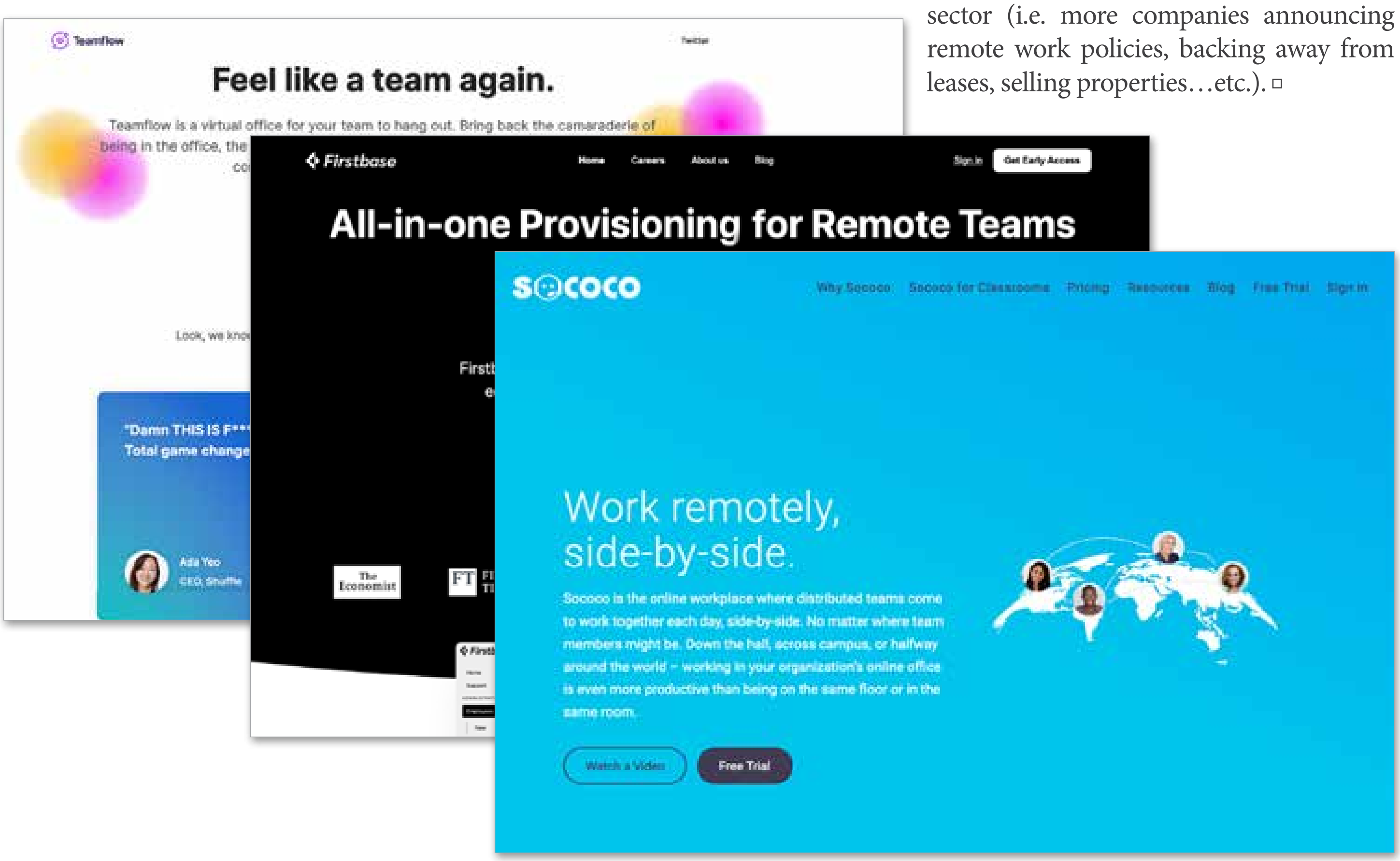
Even with disastrous occupancy, There doesn't seem to be too much distress in the office market. CMBS lenders are reporting a delinquency rate of only 1.84% in office—higher than usual no doubt—but nothing compared to the 17.53% in the hotel space and 11.33% in retail.

So there's a possibility at least that when this is all over, we could all just emerge from our houses and get back to the office. In these strange times, anything is possible. Look, just the other day there was a moment in time where Airbnb was worth more than Hilton, Marriott and Hyatt combined!



I firmly believe that life in the post-COVID world is going to largely resemble life as we lived it before. It's just that in the office market, the challenge of the pandemic has presented market participants with an incredible opportunity actually: The chance to save a lot of money on office space. I can see it already. There will be private equity funds started with the "producing returns by eliminating real estate costs" thesis. Management teams will start looking at that office line-item a little more carefully during quarterly reviews. Law firms will pare down on their over-sized, over-priced spaces. In fact, my law firm partner friends, who work at some of the largest multi-national firms in the world, tell me this is already underway. We're at the very beginning of what I think is going to be a dramatic re-sizing of office demand. To be clear, it's not a binary thing. I am not saying that offices are going away. That argument doesn't hold water either. Things are just going to change dramatically and a lot of properties are going to really struggle.

At the same time, building on the phenomenal success of companies like Zoom, the venture world is getting excited about the next wave of innovation in remote work and collaboration. There are a few companies even focused on building out the first virtual office spaces:



Is it me or do these all look and sound the same? Anyway, the point is this: the technology for remote work is likely to get better, not worse. This will put further pressure on the already stressed, rapidly changing office market.

At this point, I am bearish on office but not quite ready to start shorting office REITs and looking to buy credit default swaps on office-backed CMBS loans. In fact, I think we will likely see the public securities rally into the re-opening of the world. Amidst the general economic optimism there will be a slew of good news on declining office vacancy and improving fundamentals. This will be enough to overcome even the bad news in the sector (i.e. more companies announcing remote work policies, backing away from leases, selling properties…etc.). ▫