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Compared to Past Cycles, How Bad Has the Pandemic Been for Offices?

Summary

A two-year onslaught of gloomy, sometimes hyperbolic headlines about the future of office and cities could give casual observers the impression that urban areas are on a course to become post-apocalyptic ghost towns, with property values in steep decline. The pandemic has spurred existential dread about the office sector with fierce debate over how remote working will impact office demand, property values, and the economic viability of urban city centers.

However, doomsday headlines are at odds with empirical office performance and leasing data relative to past downcycles. At this stage, two years beyond the 2020 recession, the current downturn for offices looks **historically benign**.

Bearish views on offices have primarily relied on cherry-picked anecdotes, informal surveys, low levels of office utilization (before many companies' official "return-to-office"), and widely divergent assumptions on how much less office space tenants may lease per each partial-remote worker. Meanwhile, the real revenue impact of the COVID-19 recession has been the **least damaging** of all the booms and busts the office sector has endured over the past 50 years. So, while net office demand may or may not slip as firms gradually rationalize their office space needs for post-COVID workforces, there are simply no clear signals that we are in the throes of an "office apocalypse"… yet.

- **Office property revenues**. US office rent and occupancy rate declines following the 2020 recession are far less than the past three cycles. Many office markets mounted strong comebacks in 2021 despite uncertainty of future office space usage. New York and San Francisco offices, among the hardest by the pandemic, have office rent and occupancy declines that look minor compared to past cycles. Conventional wisdom is that Class A offices will fare better if there are fewer tenants to compete for, but that performance bifurcation hasn't broadly materialized yet in space market data.
- **Office equity returns.** Total returns for institutional office investors took a minimal hit in the pandemic downturn, dipping slightly negative only in the third quarter of 2020.
- **Office loan delinquencies.** Office loan delinquency rates never spiked through the pandemic. Despite some very modest increase in delinquencies in 2022, along with a handful of office loans liquidated at a high loss severity, the office loan delinquency rate is as low as it's been since just before the 2008 financial crisis took hold.

» **Other indicators and timing.** Other data beyond fundamental real estate performance metrics also show no clear trends of exodus from the office. Measurable clarity will take some years, as firms first resolve workforce management challenges and leases expire.

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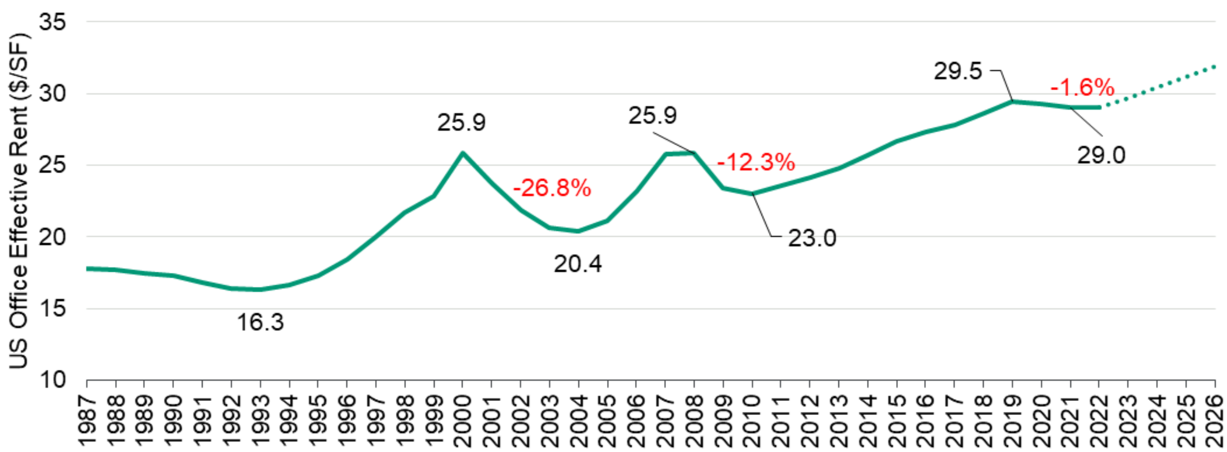
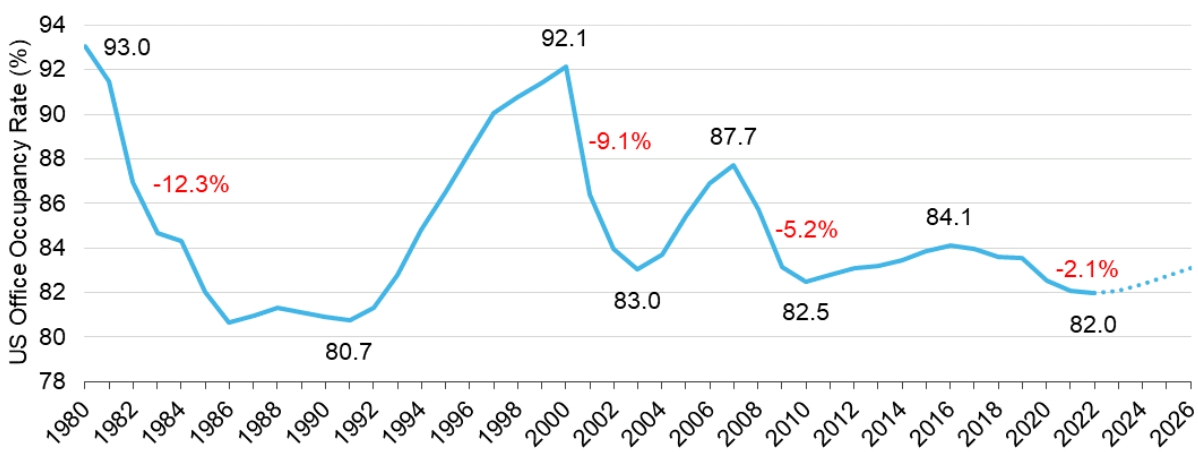
Historical context of 2020 downturn: Office property revenues

Office sector performance is "procyclical", meaning it usually moves roughly in sync with business cycles[1], but the 2020 downturn was an anomaly. The typical crash in office rents and values never came. While broad pessimism about office assets persists among many lenders and prudent investors, **the COVID-19 recession has been notably innocuous compared to preceding downturns**, despite the gloomy sentiment and uncertainty.

Figure 1 shows the US average effective rent and occupancy rate going back to the 1980s, with our forecasts out to 2026 included. Including forecasted values, the total decline in effective rent and occupancy rate is 1.6% and 2.1%, respectively. The next most mild decline was in 2008, where the declines were 12.3% and 5.2%, orders of magnitude greater than the 2020 downcycle.

Figure 1 Historical and Forecasted Effective Rent and Occupancy for US Offices





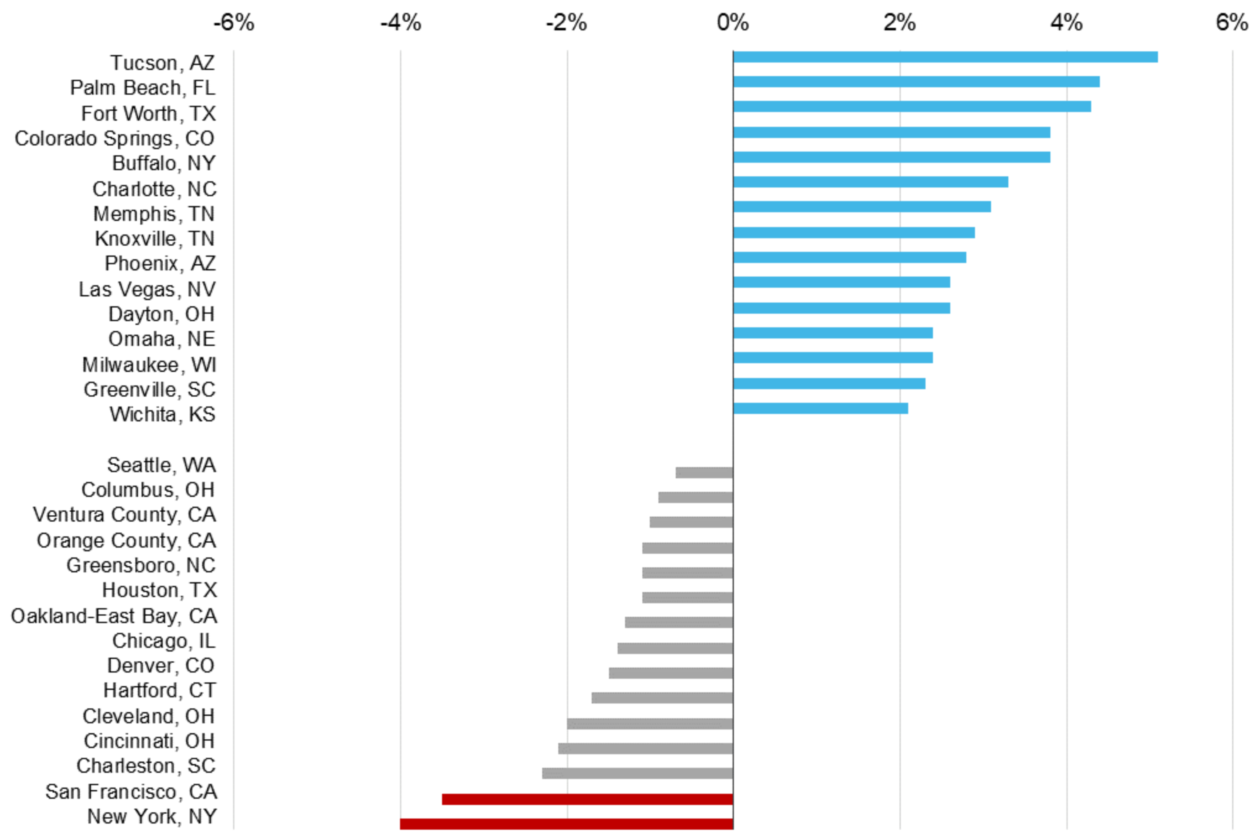
Source: Moody's Analytics CRE

[1] See description of pro-cyclicality of the office sector in "Major US office markets at a cyclical tipping point", 30 November 2017.

While the downturn for office was relatively nominal on average, some markets were hit particularly hard through COVID, while others were resilient and even saw significant rent growth as the pandemic waned last year.

Figure 2 shows the top and bottom 15 office markets by 2021 year-over-year rent growth. The chart generally reveals that many Sunbelt markets and new tech markets saw rent growth, reflecting that office demand is growing along with broader economic expansion, despite the prevalence and desire for flexible, remote working arrangements. Meanwhile, the high-density, established, and expensive markets saw continued rent decline in 2021. New York and San Francisco saw the most decline, with effective rents down 4% and 3.5%, respectively.

Figure 2 Top and Bottom 15 Office Markets by 2021 Effective Rent Growth



Source: Moody's Analytics CRE

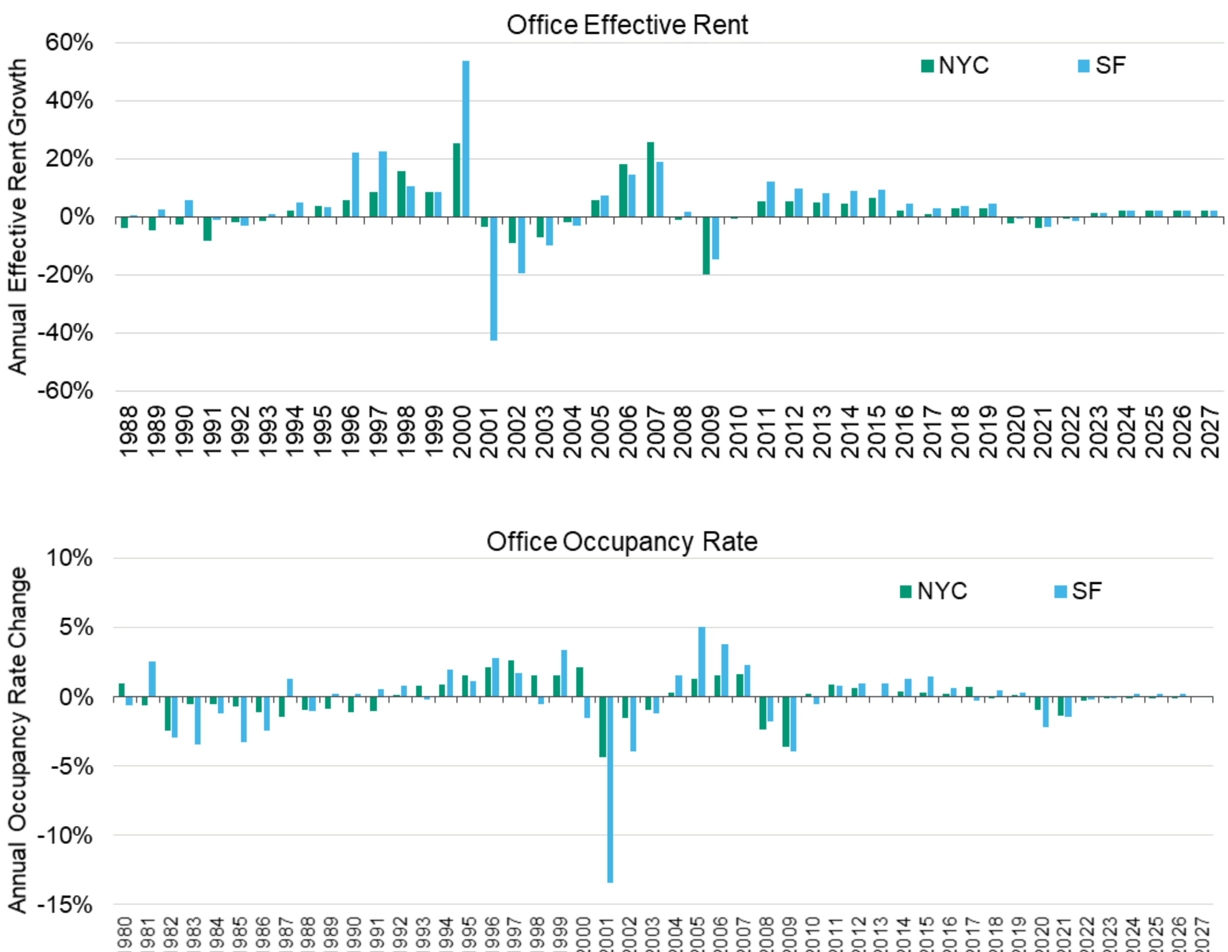
How things shook out in 2021 was is in line with [our analysis from July 2020], where we expected that the New York and San Francisco-type office markets could be most at risk because:

1. **Density.** Metros with the highest density populations, offices, and public transit would experience the most severe and longest-lasting impact of the pandemic.
2. **High costs.** Tenants would be more likely to cut the highest cost office rents, and workers would desire to cut the highest costs of living and commuting.
3. **Remote capability**. These types of metros tend to have the highest share of jobs that can be performed remotely if necessary.

However, even for the laggard New York and San Francisco office markets, rent and occupancy decline is far less than that of prior cycles. If a sea change were occurring for offices, New York and San Francisco would be likely bellwethers, given their office markets' higher potential sensitivity to disruption from remote working.

As Figure 3 shows, office performance in these two markets has been remarkably resilient relative to other business cycles. While this is not a panacea for predicting the future of office, it is strong evidence that we are not currently amid an office market crash due to a secular shift to more remote working. New York and San Francisco offices have seen much worse.

Figure 3 Historical and Forecasted Effective Rent and Occupancy for New York and San Francisco Offices



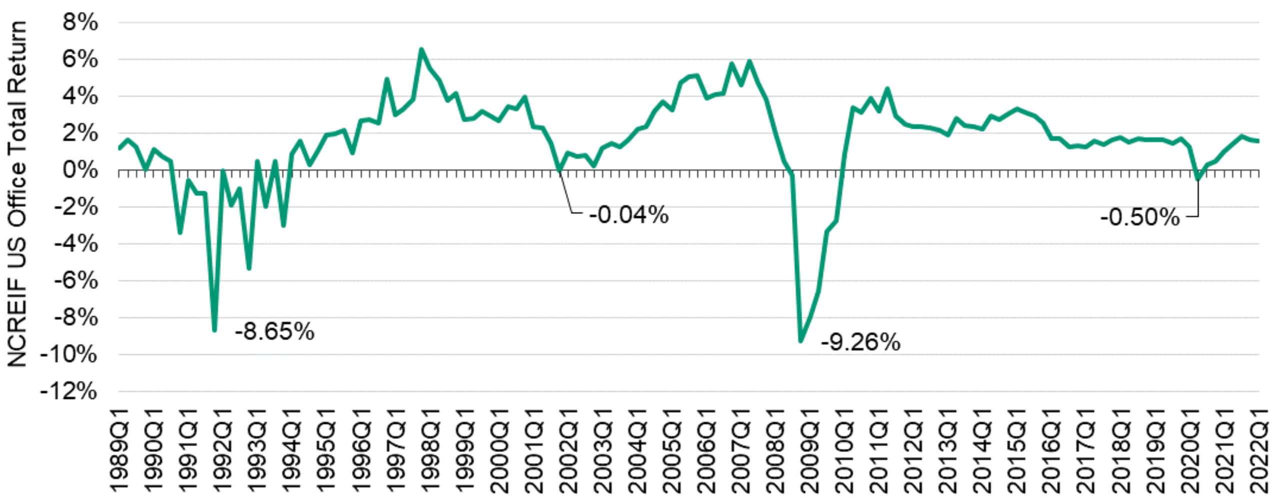
Source: Moody's Analytics CRE

Historical context of 2020 downturn: Office equity returns

Institutional office investors saw a shallow and a pronounced V-shaped cycle. Figure 4 shows that, according to National Council of Real Estate Investment Fiduciaries (NCREIF), the 2020 cycle yielded only one quarter of negative total return for office investors, as compared to the severe negative returns in the early 1990s downturn and the 2008 global financial crisis.

The set of properties behind the NCREIF return index are "institutional grade" properties, meaning they tend to be high amenity, Class A offices, supported by markets with strong and diverse economic demand and potential tenants. The strong performance of the NCREIF return index may be an indicator that the highest quality offices will be less impacted by any mass retraction in demand because they will be more competitive for a smaller pool of tenants. But by our measures, that remains to be seen.

Figure 4 Historical NCREIF Total Returns for US Offices

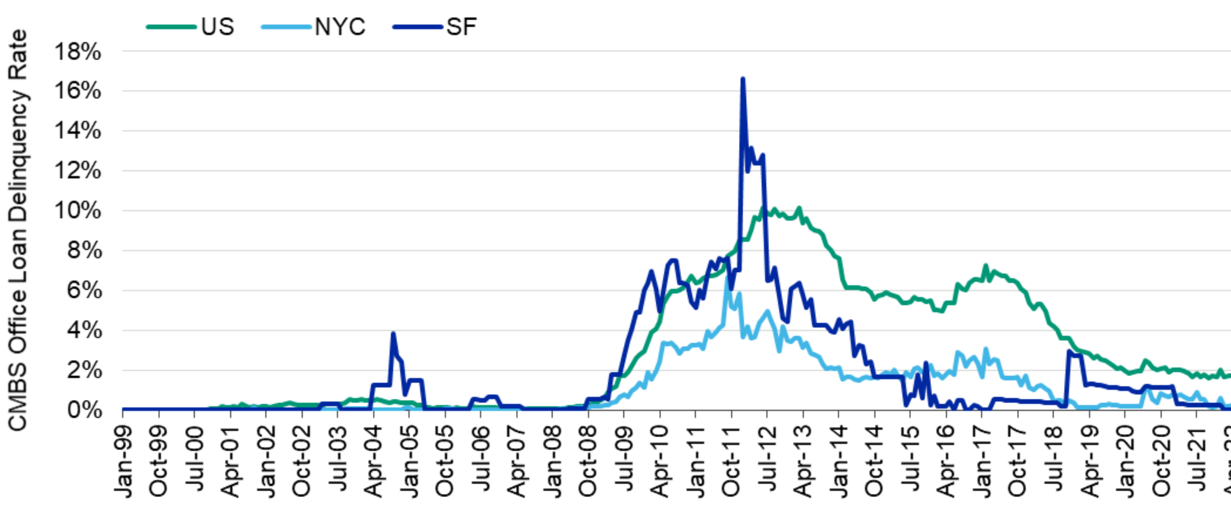


Sources: NCREIF, Moody's Analytics

Historical context of 2020 downturn: Office loan defaults

From a debt perspective, lenders saw very little losses in this cycle compared to the past. Figure 5 shows the commercial mortgage back securities (CMBS) office loan delinquency rate going back to 1999. Thus far, t**here has been no spike in delinquencies that is characteristic of a severe downturn.** In fact, delinquency rates are lower than they've been since before the 2008 financial crisis took hold, even for the hardest hit office markets like New York and San Francisco.

Figure 5 Historical Delinquency Rate for CMBS Loans Backed by Office Propert



Note: Data include all conduit and single asset/single borrower CMBS loans backed by office properties.
Sources: Moody's Analytics CMBS

Typically, for loan defaults to spike, property revenue needs to decline to the point that borrowers have negative carry after their mortgage payment, and they see no immediate option value to continue to fund the property out of pocket even if they could. As reflected by our previously cited revenue statistics and total return measures, that has not been the case in the 2020 downcycle, and therefore delinquencies have remained relatively flat for office loans over the last two years.

If our current forecast for office revenues and values hold, delinquencies should also remain broadly low. However, **as loans and leases expire over the next few years**, there may be some examples of office loan defaults and high loss severities, in some cases attributable to remote working. There may be buildings that are uniquely impacted by a large tenant lease expiration, where the tenant may exit due to downsizing of office footprint, and the property is in a small or non-diverse submarket that lacks a robust set of potential replacement tenants.

When and how will we get clarity on the longer-term impacts on offices?

While direct property performance metrics ultimately matter most to office investors and lenders, **failure tends to happen gradually, then all at once**. Therefore, it's important to also monitor other potential indicators that may flash yellow or red before they show up in property revenue and value (see bulleted list below for a few examples of such indicators we watch, with links to some of our research using these indicators).

The **summary takeaway** from our analysis of other indicators: **there are not yet any signs of a broad exodus from offices or imminently cratering property values**. There are certainly individual data points to build a case for or against the hypothesized mass exodus, but no significant trends clearly support the argument for a sustained, dramatic decline in overall office occupancy, revenue or value.

Other potential indicators of future office performance that we monitor:

- **Subleasing** - what are the availability rates, vacancy rates, and rents of subleases?
- **Expiring leases** - as compared to public commentary, what real choices are tenants making when their leases roll?
- **Lease terms** - are office leases shortening or are firms still making long-term commits to their spaces?
- **Office usage** - how are office floorplans being re-drawn and is there a net decrease in usage?
- **Remote working impact** - how does partial remote working correlate with vacancies?
- **Trends by industry** - what workplace strategies are evolving by industry, are certain industries more prone to shedding office space or expanding their office spaces, and are tech markets still outperforming other office markets?
- **Capital markets** - is pricing and volume healthy for office, is there still access to debt for office investors, and what are the loss severities given office loan default?
- **Employment and inventory** - is office-using employment growth still on par with or exceeding new office construction?
- **Obsolescence** - are offices becoming more valuable as apartments or other uses?
- **Urban preference** - are CBDs still benefiting from the draws to city living and urban amenities and services, driving apartment rents?
- **Academic studies** - are different urban economic models proving more accurate than traditional ones and what does this mean for offices?

When could we start to see definitive trends about the future of office?

As the long delayed "return to office" plans finally begin to take hold throughout the **second half of 2022**, we expect some trends may develop outside of the anecdotal noise. However, while signs may develop then, the real and lasting impact to offices will most likely start to be measurable between **2023 and 2025.** Office leases need to expire, and decisions on evolving office space needs will be a process, as we discussed in a recent webinar about future offices and workforce management.

If a major shift in office demand occurs, we expect that to come well **after** companies experiment and figure out what work arrangements are most effective for them. For typical professional services firms, the cost and importance of their human capital **far outweighs** that of the real estate they occupy[2]. Therefore, companies must first settle on their version of post-COVID-19 work and how they manage and retain their talent **before** they overhaul their space needs. For many firms, this process will take substantial time and experimentation over the course of **at least a year or two** after officially embarking on their post-pandemic era of work. Firms will also need to wait for their long-term office leases to expire. As more large tenants' **leases gradually roll over late 2022 through 2025**, the pandemic's continued damage to office values, if any, should come to light.

Until then, office tenants have been signing new leases and honoring existing leases like they haven't in past downturns, and **the office apocalypse is clearly on hold**.

[2] See Slides 26 and 27 of "Collaborative, Productive and Innovative Workspaces: Implications for Future Office Demand", Norm Miller, University of San Diego, 12 September 2012.