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Monthly Market Update

June 2023

Office Space Oddity

Once the standard bearer of stability and now faced with uncertainty, what does the future look like for office real estate?

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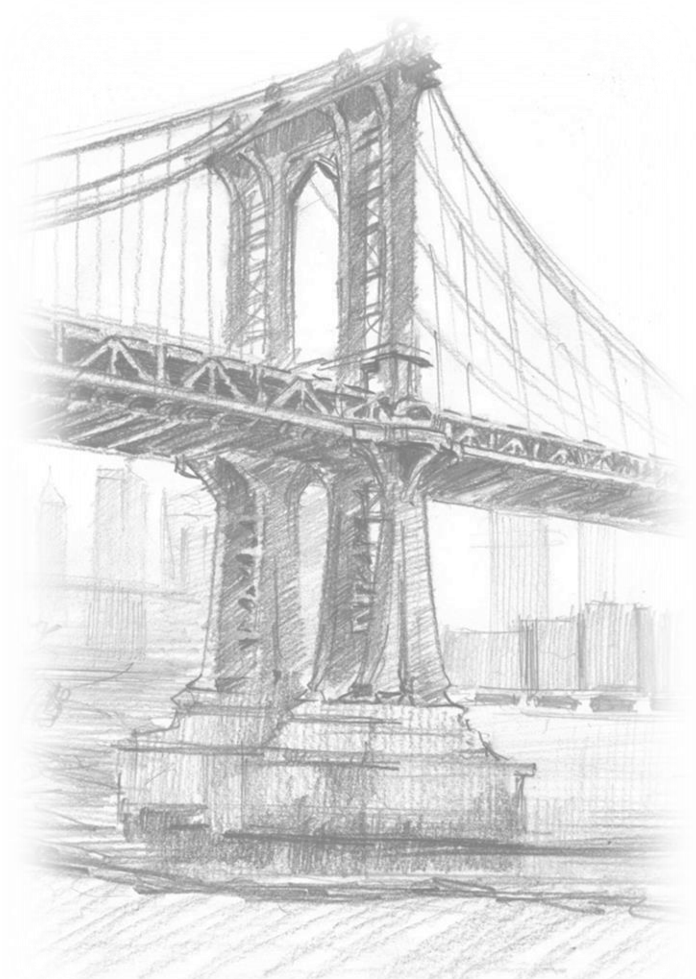
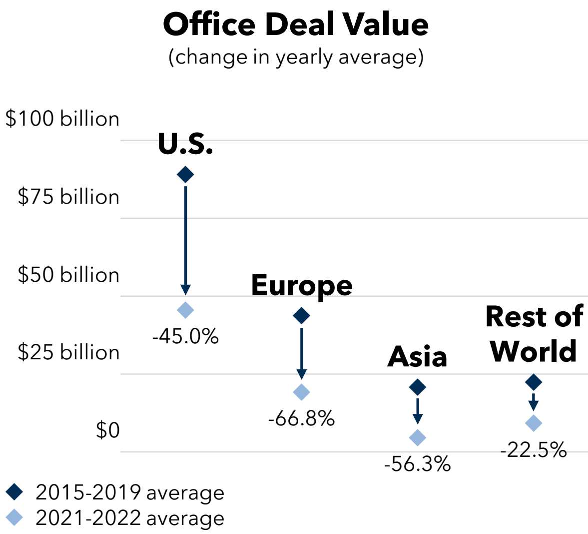


After a multi-year push for a "return to office" for employees, many companies have found work-from-home and hybrid accommodations to be a sticky benefit, with office landlords and investors feeling the brunt of this societal change.

The average office deal value in the U.S. has dropped by almost 50% since before the pandemic (Chart 1), with declines across all major metropolitan areas. Combined with higher interest rates, this once stable property type is now facing significant uncertainty and volatility regarding occupancy, revenue and valuation.

Does this confluence of timing and circumstance present investors with opportunity? Or should they consider other property types as they build their real estate portfolios?

Chart 1



Source: Preqin Pro. Data as of April 2023

While office leasing space was on its way to recovery after several years, quarterly leasing activity has seen steep declines for the past three quarters, as illustrated in Chart 2. Leasing activity by square feet in the first quarter of 2023 sits at less than 64% of the pre-pandemic average.[1]

Under Pressure

Despite the recent decline in leasing activity, many companies with large workforces continue to roll out return-to-office policies, which have helped push the Kastle workplace occupancy index beyond 50% for the first time since the pandemic.[2] Without question, the upward momentum of the index is a positive note.

However, the full picture is far more complicated. Many major cities are only halfway back to pre-pandemic daily occupancy levels, and in several metro areas these levels appear to be slowing in growth.

The concept of a hybrid work policy has been magnified. While some employers may have experimented with work-from-home and hybrid policies before 2020, the mandated at-home work environment accelerated its growth. And in many cases, it has certainly become the norm. A deeper dive into the data reveals a major divergence between what are currently the highest- and lowest-occupied days of the week: 57.6% (Tuesday) and 32.4% (Friday).[2] This would imply hybrid policies continue to expand. While these data points highlight the commitment by many companies to embrace the creation of a better employee experience, it places doubt on the widespread implementation of pre-pandemic, full-week, in-office policies.

Not surprisingly, the empty office space has not gone unnoticed by landlords. To counteract, they are doing all they can to attract signers to long-term leases. In return for the long-term ask, the leases are now being peppered with tenant-enticing concessions.

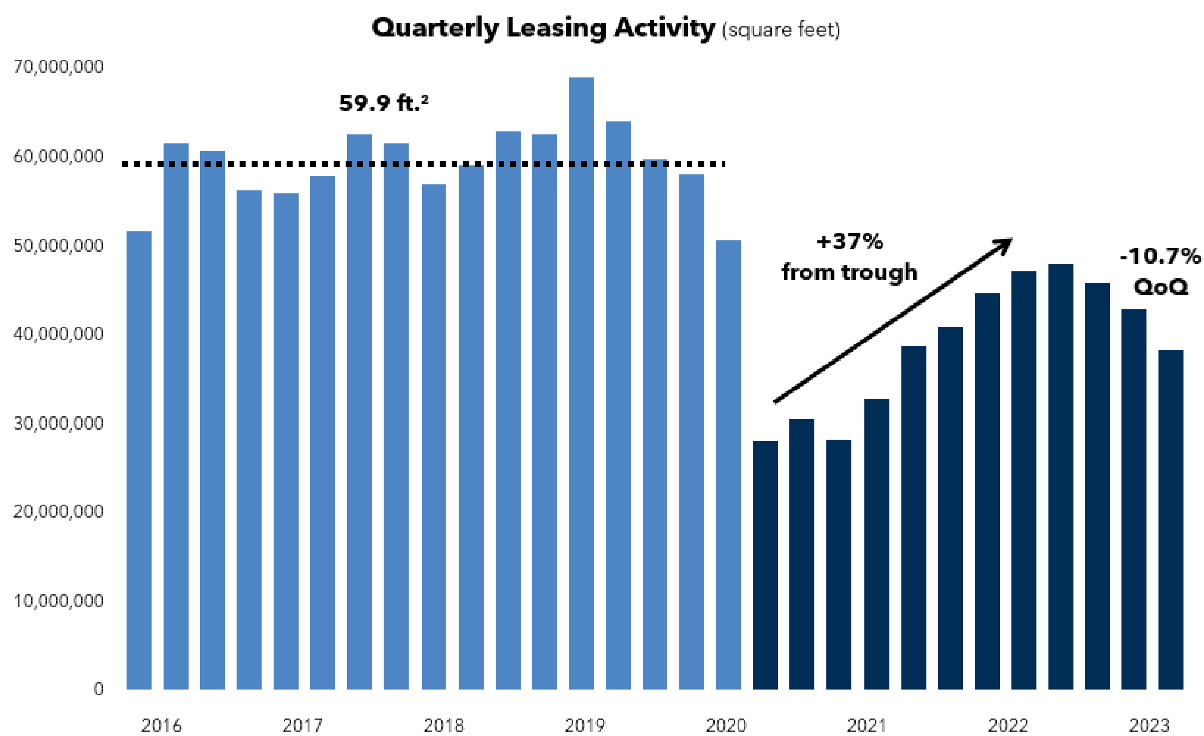
- Asking rental rates have been relatively stagnant, up just **1% YoY**
- Tenant improvement allowance is up **5% YoY**
- Free months are up **11% YoY**, with landlords giving away nearly **10 months for free** over the course of a 10-year lease[1]

The Rise and Fall

Since the onset of the pandemic, office REITs have not recovered and are down an additional 20% so far this year (see Chart 3). Despite attractive yields in the high single digits or even the mid to high teens, many office REITs are paying out dividends far exceeding current income. If headwinds persist, these high payouts may be slashed or suspended all together.

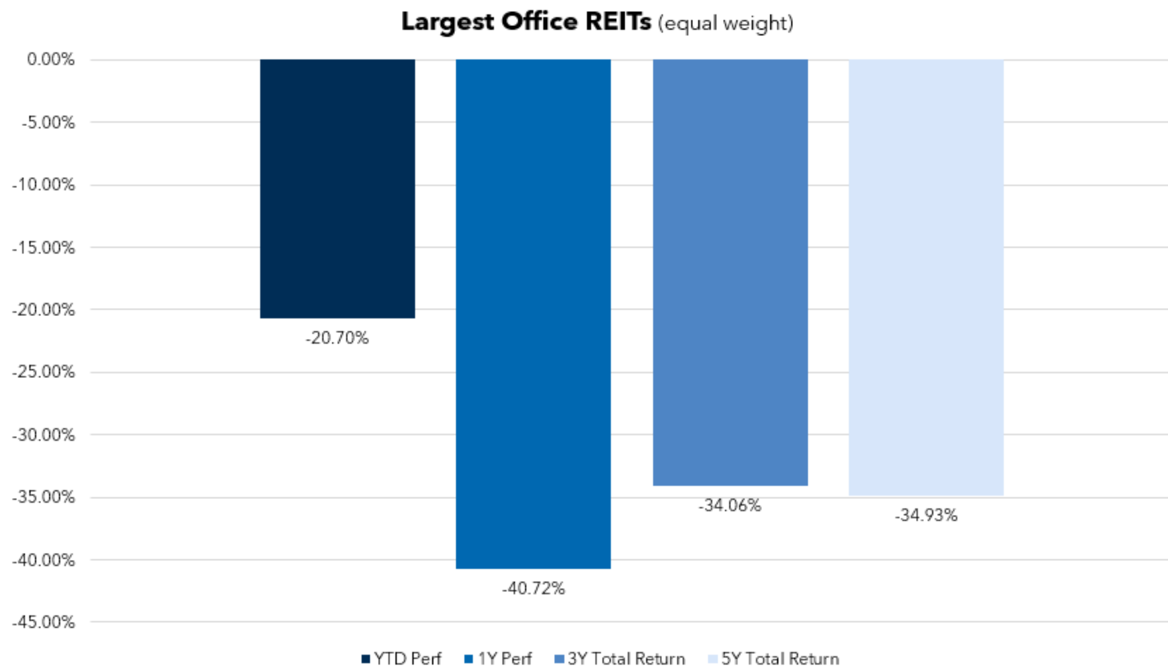
The critical question investors must ask themselves: is this an opportunity or the new reality?

Chart 2



Source: JLL Research

Chart 3



Source: Dow Jones

Though occupancy rates and work-in-office trends are heading in a favorable direction for office landlords, the stickiness of work-from-home and hybrid policies, as highlighted earlier, may be much more persistent than they might hope for. They might, perhaps, even be permanent.

Considering this, investors may wish to look elsewhere to balance their real estate exposure. As we have highlighted in our previous market updates, “There’s No Place Like Home” and “Break on Through (to the Other Side),” multifamily and hospitality properties offer resilient sources of growth and income and are benefiting from strong macro tailwinds.

In the end, an investor’s best chance of success across all asset classes falls upon finding managers with defined expertise, aligned investment principles and building a portfolio through a holistic lens.

For information on PPB’s alternative fund platform, please contact:

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Footnotes and Important Disclosures

[1] https://www.us.jll.com/content/dam/jll-com/documents/pdf/research/americas/us/jll-us-office-outlook-q1-2023.pdf

[2] https://www.kastle.com/safety-wellness/getting-america-back-to-work/

Additional source: https://www.preqin.com/insights/research/research-notes/once-the-hot-property-in-real-estate-offices-are-at-a-crossroads

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