

A Spartan Race Is Scheduled For Some Office Owners

One year ago, today the country shut down and I left my office for what I thought *may* be a few weeks. A few has turned into 52 and a new pandemic has changed the commercial office market in ways we never imagined a year ago. For owners and occupiers of some office buildings, the challenge in the years ahead will be like A Spartan Race. For those not familiar, Spartan Race is the world's premier obstacle course race, a running race with the additional challenge of obstacles along the course. These obstacles require athletes to have a highly-conditioned fitness level (cardiovascular fitness + strength + mobility) and a strong desire to finish the race.

The pandemic has caused employers to throw out their old real estate playbook and re-prioritize their real estate strategies for the future. Estimates range from 5-7% for those who worked remotely pre-pandemic and new estimates predict that at least two-thirds of the workforce want to work remotely at least 1-2 days per week in the future. The result from this reduction of time spent at the office along with other industry changes has started a long path of challenges and obstacles for office owners, particularly those with high-rise buildings in a city center.

Will this be the end of office buildings as we know them, no, but there will be serious disruption as we define the new normal. As employers focus on flexibility, new office designs and closer management of their leased real estate, shorter term leases and a reduction of leased space will negatively impact the office market. Reduced rent income coupled with additional capital requirements for post-pandemic building accommodations (think new air quality systems, software to track density of employees, additional cleaning requirements, etc.), one can conclude that this will impact values and cause concern about the ability to service the debt. Inevitably, restructuring debt and entire capital stacks will play an increased role in the years ahead.

Many challenges will likely be concentrated in major metropolitan areas with high-rise office towers previously packed with employees who mostly commuted to work using mass transit. Employers who recently established new mandates to reduce space will also be less inclined to commit to long-term leases. New office spaces will be designed with an eye towards flexibility, enhanced productivity and collaboration, yet also incorporate the post-pandemic needs for spacing, flexibility in furniture layouts, cleaning standards, air quality, etc.

One of the most closely watched metrics will be what happens when current leases expire. The key is how much of an exodus will there be from city centers by employers establishing new locations closer to where their employees live. The theme we now hear about work/life balance is here to stay. A new location closer to where employees live will help with the work/life balance by shortening commuting headaches (packed trains and buses, long drive times) that were previously the norm.

A result of this will be increased vacancies in central core office towers. While this will cause significant challenges for central core high-rise office buildings, it is unlikely that the impact to the entire office sector will be severe. For example, well-located and newer suburban office product in growth markets that can accommodate the post-pandemic changes employers are making can thrive.

Ultimately, all of this disruption will work its way through the system and things will get better, but there will be damage along the way. In the long run, we will likely see employment growth offset many pandemic related reductions in space, resulting in higher occupancies, increased rents, increased asset values, and newly constructed buildings.

However, there are risk-mitigation strategies that can be established to lessen the impact, but those need to be developed and implemented now. A large office tower cannot reimagine and enhance common areas, HVAC systems, office space, technology and its brand overnight. It is a long process.

The challenge central core office owners face in the next few years is analogous to a Spartan Race - a long course with many ups and downs that deliver bruises, broken capital stacks and some severe injuries along the way. Only those with a well thought through strategy, highly-conditioned fitness level and mental toughness will survive.

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