January 2021

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Office Capital Flows Curbed by Uncertainty

- COVID-19-related trends led U.S. office transaction activity to drop by almost half in 2020. Some $56.1 billion of office properties traded last year, down 46.9% from $105.6 billion in 2019, according to Yardi Matrix data. The impact was felt broadly by region, with only a handful of exceptions.

- By region, gateway markets and the Northeast fared better than most secondary and tertiary markets. Markets in which sales held up in 2020 have strong niche sectors, such as life sciences, biotechnology and pharmaceuticals.

- The pandemic introduced a great deal of uncertainty into the market that contributed to the decline. The roadblocks to transactions include logistics and the diminished availability of debt. But the biggest uncertainty involves pricing properties when most office workers are working from home and corporations are assessing future space needs.

- Sales dropped sharply in many "hot" markets where population and employment are growing (such as Austin, Atlanta and Miami), mainly due to a lack of willing sellers. Owners in those metros that have no compelling reason to offload assets are waiting for the downturn to end.

- Rent collections remain well above 90%, even though most office-using jobs have moved to a work-from-home model. While this has created stability over the short term for offices, questions abound over the utility of office space and future space needs. The pandemic has demonstrated that work-from-home can be effective, but questions remain about productivity and how corporate culture and onboarding are achieved remotely.

- Investors by-and-large are taking a wait-and-see approach to 2021. Transaction activity is likely to remain tepid through mid-year or longer. As vaccines are becoming available, offices will re-open, but it remains unclear when most workers will return.

Buyers, Sellers Far Apart

Sales activity started the year strong—$22.1 billion of offices changed hands in the first quarter, up 20% year-over-year. But as lockdowns began and offices closed beginning in March, second quarter transaction volume plummeted to $8.6 billion, down 64.7% year-over-year and the lowest quarterly total since the third quarter of 2010. Sales remained slow the rest of the year, with $9.3 billion in the third quarter, down 68.3% year-over-year, and $16.0 billion in the fourth quarter, down 51.7% from 4Q19.

Post-COVID-19, many deals were put on hold or canceled as lockdowns put much of the sector on hold. Logistics were difficult as public institutions closed and travel restrictions delayed site visits, property inspections and filing of necessary paperwork. Financing of some deals dried up, as many lenders temporarily put originations on hold in the spring and limited leverage to 55% of property cost when they resumed in the second half.

As the pandemic raged, corporations quickly shifted to a work-from-home model. Although not nearly as hard-hit as low-wage service job segments such as leisure and hospitality or food and beverage, office-using employment fell 4.9% during the first six months of the pandemic. A rebound in the fourth quarter left 32 million office-using jobs at year-end, a 3.4% decline year-over-year. With the easing of restrictions and the COVID-19 vaccine becoming more available, more jobs will return, although the full impact is still to be determined.

Whatever happens in the short term, the biggest impediment to deal flow is uncertainty surrounding the future use of offices. The success of the work-from-home model in many industries has led some to predict that many occupiers will

Transactions by Region (Mil)

	2020	2019	YoY Change
Northeast	$16,054	$22,505	-28.7%
National	**$56,063**	**$105,623**	**-46.9%**
Midwest	$3,743	$7,418	-49.5%
West	$20,485	$41,002	-50.0%
Southeast	$11,156	$23,519	-52.6%
Southwest	$4,624	$11,179	-58.6%

Source: Yardi Matrix

Transactions by Market Size (Mil)

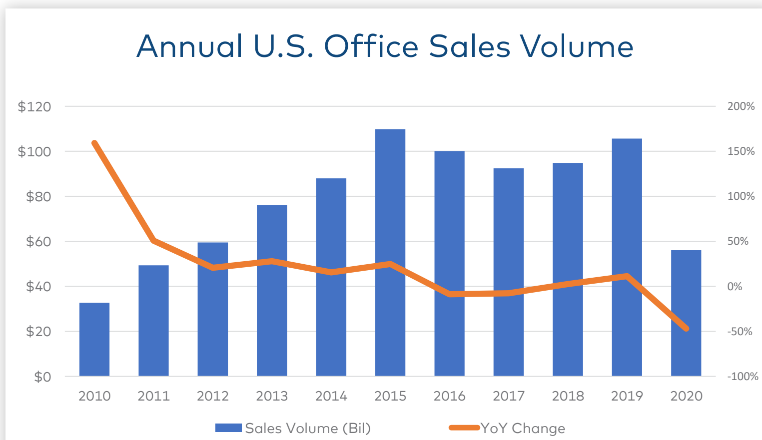
	2020	2019	YoY Change
Gateway	$30,934	$49,805	-37.9%
National	**$56,063**	**$105,623**	**-46.9%**
Tertiary	$5,005	$9,990	-49.9%
Secondary	$20,124	$45,828	-56.1%

Source: Yardi Matrix

Transactions by Location (Mil)

	2020	2019	YoY Change
Urban	$15,643	$28,149	-44.4%
Suburban	$29,392	$53,075	-44.6%
CBD	$11,028	$24,399	-54.8%

Source: Yardi Matrix



Source: Yardi Matrix

downsize space needs or move to less expensive locations. The concern over future cash flows has caused some buyers to adopt a wait-and-see strategy and widened the gap between buyers and sellers. Buyers are seeking 15-20% discounts for lower occupancy rates and rents in the future, while sellers want full credit for existing cash flow.

The upshot is that many sellers sat on their properties. Most deals that were able to get done involved high-quality assets with limited risk: stabilized, fully occupied properties with long-term leases. Consequently, the average price per square foot of properties sold in 2020 showed an increase of 8.2% year-over-year, to $293 per square foot from $271 in 2019, even though acquisition yields increased by 15 to 60 basis points depending on the location and building class. The growth in price per foot was concentrated in urban centers (18.7%) and gateway markets (9.7%).

Despite the low rate of utilization—10-25% in most major urban centers—there has been very little distress in offices so far, as many landlords are reporting rent payments of 95% or more. As of December 2020, only 2.2% of loans backed by offices in CMBS pools were delinquent, basically unchanged during the pandemic and well below the 7.8% average for all loans, according to Trepp. What's more, forbearance policies enacted by lenders and servicers will prevent a wave of distressed office sales anytime soon.

Secondary Markets Take the Biggest Hit

Declines in transaction volume were not consistent across regions. Gateway metros and the Northeast fared far better than the rest of the country. Volume in the Northeast fell 28.7% year-over-year, mainly due to the strong performance of New Jersey and Boston. In the Northeast, urban (-19.4%) and suburban (-4.8%) volume fell less than the 54.8% drop in CBD properties.

Transactions by Metro (Mil)

	2020	2019	YoY Change
New Jersey	$2,264	$1,990	13.8%
Boston	$5,780	$5,842	-1.1%
Chicago	$1,924	$2,275	-15.4%
Portland	$982	$1,165	-15.7%
Los Angeles	$3,338	$4,945	-32.5%
Nashville	$804	$1,197	-32.9%
Dallas	$1,779	$2,986	-40.4%
New York	$5,824	$10,377	-43.9%
San Francisco	$3,917	$7,111	-44.9%
National	**$56,063**	**$105,623**	**-46.9%**
Philadelphia	$984	$1,973	-50.1%
Bay Area	$3,936	$8,146	-51.7%
Denver	$1,347	$2,950	-54.3%
Charlotte	$927	$2,063	-55.1%
San Diego	$982	$2,192	-55.2%
Washington DC	$3,767	$8,581	-56.1%
Houston	$1,315	$3,189	-58.7%
Phoenix	$921	$2,495	-63.1%
Seattle	$3,377	$10,004	-66.2%
Miami	$345	$1,039	-66.8%
Tampa	$270	$906	-70.2%
Twin Cities	$471	$1,594	-70.5%
Orlando	$175	$663	-73.6%
Atlanta	$713	$2,862	-75.1%
Austin	$176	$1,735	-89.9%

Source: Yardi Matrix

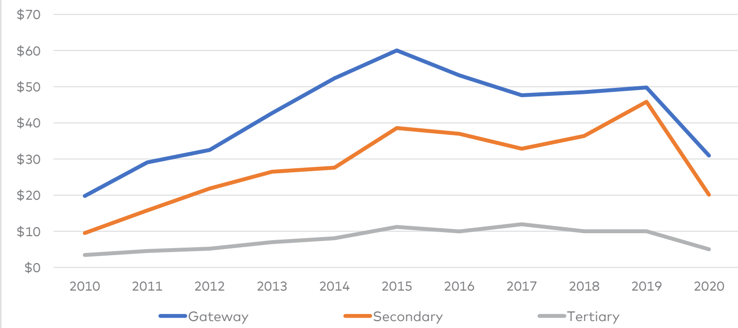
Every other region of the country fell by half or more. Southwest volume fell 58.6% despite the region having solid fundamentals. The drop in volume in the Southwest (-65.4%) and the Midwest (-61.1%) was due to weakness in CBDs, while in the Southwest the decline was concentrated in reduced volume in suburban submarkets (-59%).

Looking by market size, sales in gateway metros fell by only 37.9%, outperforming the national average. Washington, D.C. (-56.1%), San Francisco (-44.9%) and New York (-43.9%) saw large declines in volume, but Boston (-1.1%), Chicago (-15.4%) and Los Angeles (-32.5%) had relatively smaller declines. Secondary markets (-56.1%) had the largest drop in volume, while tertiary markets dropped by half (49.9%).

On a metro level, sales volume varied widely. Of the 25 largest office markets, Northern New Jersey (up 13.8% to $2.3 billion) was the only market with an increase in deal flow, while Boston (-1.1% to $5.8 billion) was virtually flat. The common ground between those metros is that both have significant industry concentrations in pharmaceuticals, biotechnology and life sciences, which are in demand due to the impact of the pandemic.

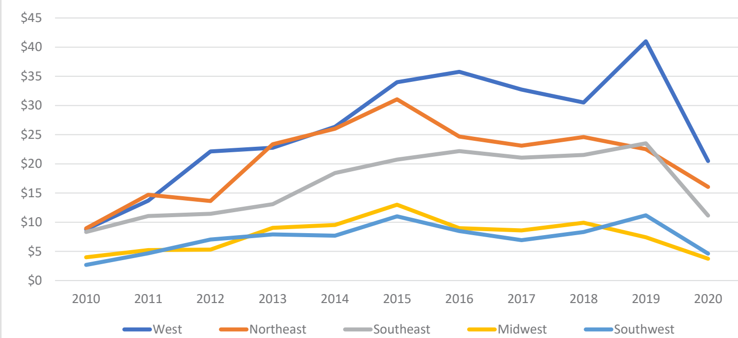
Sales activity fell the most in Austin (-89.9% to $176 million in 2020), Atlanta (-75.1% to $713 million), Orlando (-73.6% to $175 million), the Twin Cities (-70.5% to $471 million) and Tampa (-70.2% to $270 million). Many markets with low volume are places where companies are moving to escape high-cost gateway metros (examples: Miami, Phoenix, Charlotte and Denver), so the problem is less a lack of investor interest than owners that are bullish and have decided to hold on to assets until prices recover.

U.S. Office Sales Volume by Metro Size (Bil)



Source: Yardi Matrix

U.S. Office Sales Volume by Region (Bil)



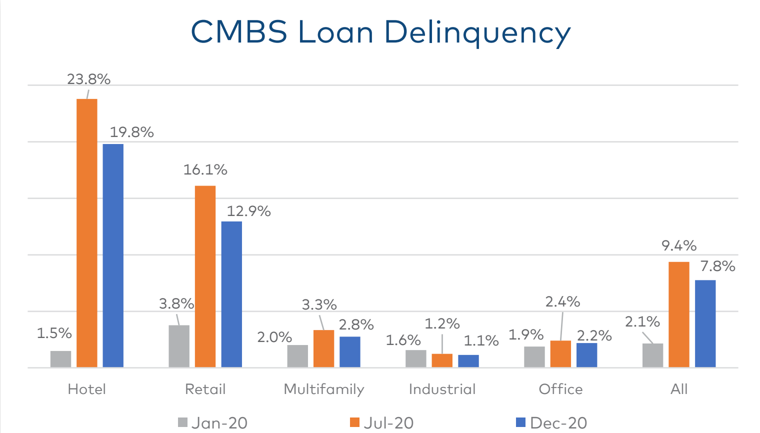
Source: Yardi Matrix

Whither Offices?

Office might not be the worst-performing sector of commercial real estate, but it is the most difficult to predict going forward. Much capital has flowed toward favored industrial and multifamily sectors, which have positive demand drivers, while retail and hospitality are anticipating large amounts of distress in coming years. The views about the office sector, however, are much more diverse. Pre-pandemic, job growth was centered in urban hubs and "walkable" downtowns, with amenity-laden offices that encouraged socialization and teamwork to attract young knowledge-based talent.

The pandemic quickly changed that. Offices that could manage it asked the bulk of their workforce to work from home, and many companies plan to keep offices closed throughout 2021, while others are giving employees flexibility to return. The ability to maintain levels of productivity outside of an office may lead some companies to reconsider their office leases in the future. The flexibility inherent in modern office space has enabled it to stay afloat during the pandemic and keep rents paid, but as lease renewals come up, the question of whether to stay or go will weigh heavily on the future of offices.

Office space may become a luxury asset as companies opt to downsize significantly or move entirely to a work-from-home business structure. Shorter lengths and flexibility in the terms of lease



Source: Trepp

agreements may become the norm, as risk of further shutdowns could put further strain on businesses in precarious financial situations. Owners will need to get creative to keep their current tenants and lure future occupants.

Moreover, companies that choose to keep their office space will likely need to find ways to entice professional talent back from the convenience of their home offices. A switch to accommodations with more desirable amenities may become necessary to offset the inconvenience of commuting and the risks of COVID infection. One of the main drawbacks of working from home is the socialization lost among coworkers. Spaces that can accommodate social spaces, such as recreation rooms, gyms, etc., could tip the scales and lure workers back to the office.

Challenges Ahead

With all the challenges surrounding offices—including weak demand at a time of rapidly rising supply, the inability to fully use offices until vaccines create a herd immunity, questions about corporate downsizing due to work-from-home policies, and the likely need for increased capital expenditures to combat health risks and renovate to meet demand for new amenities—transaction volume is likely to remain weak in 2021.

The sector could benefit from overall investor demand for commercial real estate, which is attractive relative to low-yielding fixed-income products. What's more, some investors are likely to migrate to offices because property yields will be higher than the in-favor industrial and multifamily segments. However, volume is likely to remain tepid through at least mid-year and probably longer as the uncertainty takes time to subside.

—Paul Fiorilla, Director of Research,
and Casey Cobb, Senior Analyst

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