The "Under-Demanded" Office Market

By John McNellis

The following is a developer's view of today's built environment as a result of COVID and work-from-home restrictions. STRUCTURE believes it is important to visualize how these factors can influence the field we work in. This regional example is reflective of many areas around the U.S.

The swallows abandoned San Juan Capistrano in the 1990s. Their home – the historic mission – underwent a renovation; the birds lost their ancestral nests and, despite every effort to lure them back, they have yet to return in meaningful numbers. No less flighty, workers abandoned their office buildings in 2020. They, too, have migrated elsewhere. Those in real estate ask themselves *when* office employees will return. Others wonder *if* they will return. Back to that existential question in a moment.

Global Commercial Real Estate Services (CBRE) has just published the 2nd quarter results for San Francisco's office market. Almost 29 percent of the city's office space – about 25 million square feet – is now available. Vacancies increased by 362,000 feet in the 2nd quarter, and about 550,000 feet of brand-new office space is coming on line soon. In short, the vacancy rate is climbing toward a cloud-obscured peak. One industry executive wryly observed, "We're not overbuilt, we're under-demanded."

Turning this data around, 71 percent of the city's buildings are leased. Sadly, that figure is somewhat misleading. In these "covidy" times, a building's occupancy rate is a far more critical metric than its leased rate. Kastle Systems, a workplace security company that requires office employees to swipe entry cards, provides precise occupancy data. As of this writing, San Francisco's overall occupancy rate – the workers who actually show up – is 39 percent.

A 39 percent occupied building may have a happy ending, but like falling in love with someone with a bad heart, you could find yourself praying in the emergency room before it is all over. Meanwhile, with the exception of the swankiest buildings – say, Sales Force Tower – rents are plummeting; tech is down 24 percent on the NASDAQ and shedding workers like winter coats in Miami.

None of this is news to the office world's big hitters, major league owners, lenders, and brokers. In fact, the country's biggest banks have all but ceased lending on high-rises, and big equity, the kind you need to buy a $500 million building, has run for the exits. "There is almost no liquidity in the office market today," a seasoned mortgage broker proclaimed. "No one knows where pricing will be when one of these towers finally does sell." I asked a handful of industry leaders how much high-rises had dropped in value over the last two years. Their guesses (yes, guesses) ran anywhere from a decline of 25 to 60 percent. This broad lack of consensus is part of the problem; without consensus on value, there is no marketplace, leaving office buildings buried under ten feet of permafrost.

Why? Back to those missing workers. No one (including this writer) knows how many employees will eventually return. Assuming you are OK with deep recessions, the rosy scenario for a prodigal worker homecoming goes like this: tech's massive lay-offs will continue, employers will regain the whip hand, and they will force their employees' return. One pundit believes that clever workers will come back on their own once they realize that remote working sets them squarely at the lip of Mount Doom. How? If work remains remote, if employers capitulate to it, companies will stop paying $220,000 a year to some guy coding from his Snake River shack when they can get the same quality from Mumbai for $90,000.

The problem with this homecoming prediction is its underlying assumption that tech actually wants its employees back. I asked a half-dozen CEOs of small to mid-sized tech companies how efficient they were running remotely. This one had total consensus: they are all humming along, 90-100 percent as effective as they were pre-Covid. That may not be true for the FAANGs of the world (an acronym for the five most popular and best performing tech stocks in the market), and it certainly is not true for start-ups; everyone agrees that nascent companies require all hands to huddle endlessly. But between Google and a garage venture, there must be hundreds, if not thousands, of companies with no need to revisit downtown anytime soon.

The author's essays recently insisted that, despite all the troubling economic news, real estate would cough up few good deals because of the trillions in opportunity funds desperately seeking yield. Office buildings could prove an exception. In five or six years, we may well look back at 2023-24, whack ourselves on the forehead, and swear, "How the hell did I miss that? I could have bought a Class A office for fifty cents on the dollar."

If you are willing to place a career bet on the return of the swallows, you could possibly reap the biggest reward real estate has offered since 1992. For what it's worth, I do think the city will right itself, the employees will return, and landlords will once again toast each other's brilliance. I'm just glad I don't have to bet on it.▪

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