American Assets Capital Advisers

A SPECIAL REAL ESTATE MARKET COMMENTARY

Don't Come into the Office Today

SIGNIFICANT HEADWINDS FOR THE OFFICE SECTOR

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THEMES

COVID-19, office sector, lifestyle shifts

READ TIME

15 minutes

Technological advancements have given us the ability to work remotely, but it wasn't until COVID-19 that society gained a general acceptance of this. We at AACA expect this (and a handful of other structural shifts) to create significant headwinds for office landlords for decades to come. While there may be relative winners and losers in this scenario, we hold that office valuations do not reflect the new reality for the sector – particularly in dense gateway markets like New York City.

Executive Summary

Five Structural Shifts

❶ Work from Home (WFH) Trend

COVID-19 has normalized remote working and proven viable to employers. Experts believe reduced in-office work may cause office space demand to decline by 10%-15%.[1]

IMPACT ON OFFICE DEMAND: NEGATIVE

❷ Density Lifestyle Shift

COVID-19 and social distancing requirements may reverse decade-long trends toward denser office space and move towards a less-dense "horizontal" office environment.

IMPACT ON OFFICE DEMAND:

NEGATIVE FOR HIGH-DENSITY VERTICAL

POSITIVE FOR LESS-DENSE HORIZONTAL

❸ Office Employment Rate

There have been mass layoffs and unemployment in the COVID-19 environment. The pandemic will not be permanent, but it has created a recession and may have a lasting impact on the demand for office space.

IMPACT ON OFFICE DEMAND: NEGATIVE

❹ Tenant Shift to Lower-Cost Environments

Financial and non-financial costs to the employer and the employee will create winning and losing markets. Financial (high vs. low taxes); health/safety (old/crowded vs. new/social-distanced); difficulty (high vs. low-regulation); quality of life (cost of living).

IMPACT ON OFFICE DEMAND:

NEGATIVE FOR HIGH-COST MARKETS

POSITIVE FOR LOW-COST MARKETS

❺ Increased Landlord Spending for Tenant Retention

Office landlord costs have increased to 45% of NOI.[2] Tenants may require improvement packages. Most office buildings may require CAPEX investment to reconfigure the space to meet post-COVID requirements.

IMPACT ON OFFICE DEMAND: NEGATIVE

1 GreenStreet Advisers: "Office Insights," 6/30/2020.

2 NCREIF

❶ Remote Working and Work from Home Trend

“We’ve proven we can operate with no footprint. Can I see a future where part of every week, certainly part of every month, a lot of our employees will be at home? Absolutely.”

-James Gorman, CEO of Morgan Stanley

In our opinion, the work from home (WFH) trend is not temporary. We, as a society, have had the technology for many office-based jobs to work remotely for years; however, it wasn’t until COVID-19 forced a mass WFH “experiment” that everyone realized WFH works better than we thought.

Corporate America has traditionally been suspicious of WFH and employees “goofing off” if they are not in the office. In addition to the revelation that WFH actually works, Corporate America is realizing they do not need to pay for so much office space and could reduce their cost structure if some of their employees did work remotely. Today, many companies are just starting to restructure to this new reality.

We believe that many jobs will never return to the office post-COVID, and many more jobs will leave the office over the next decade. COVID-19 has normalized WFH and most experts believe office demand will decline 10%-15% because of this trend.[3] This is a serious headwind for office landlords, as normal office demand growth is roughly in line with population growth (0.5%-1.5% per year). This is a structural change, not dissimilar to how the long-term e-commerce trend has hurt mall and retail landlords’ ability to find tenants.

[3] GreenStreet Advisers: “Office Insights,” 6/30/2020.

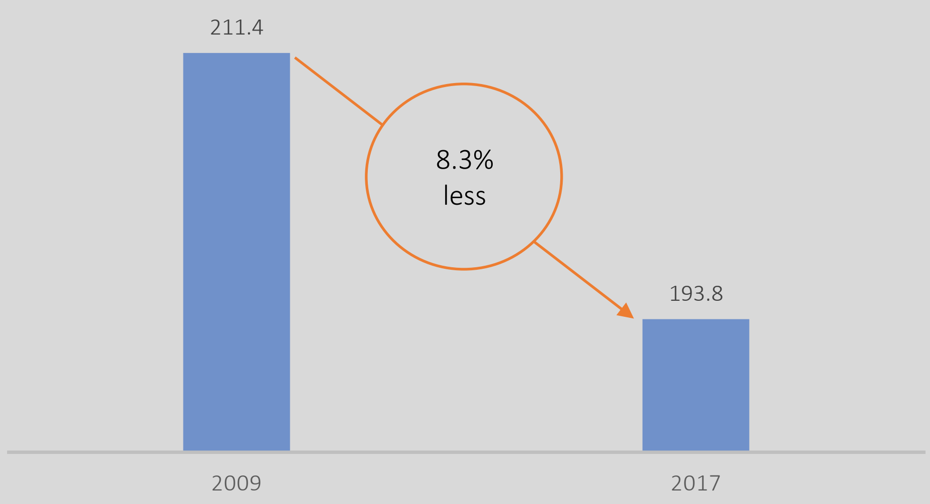
❷ Shift from a Dense “Vertical” Lifestyle to a Less-dense “Horizontal” Lifestyle

Employers have been squeezing more people into less office space each year. The last decade has seen a reduction of about 1% per year in office square footage per employee, which really adds up over time.[4]

FIGURE 1

CRAMPED OFFICE SPACE

OFFICE SQUARE FOOTAGE PER PERSON



Source: Cushman & Wakefield: "The Rise of Open Spaces," February 21, 2019.

[4] Cushman & Wakefield: “The Rise of Open Spaces,” February 21, 2019.

Employees have conventionally moved to city centers, like New York City, for a host of reasons including job opportunity and mentorship, but also for the suite of amenities the city offered in the way of restaurants, bars, clubs, and entertainment venues. Traditionally, these amenities balanced out the expense and lower quality of life (cramped living spaces, high cost of living, urine-soaked subways, etc.) that came with the city. During a pandemic, however, the costs and amenities of the city have fallen out of balance. With both the office and the amenities closed, many people feel as though there are no reasons left to live in the City.

Similarly, employers are under constant pressure to reduce cost. If employers can no longer reduce costs through densifying and desk-sharing, remote working is the new low-hanging fruit to reduce their office footprint. However, once sent home, the next obvious question for the employee is, "Why am I paying NYC rent if I don't have to be here for work and none of the amenities are open?" The employers then ask themselves, "Why I am paying an employee NYC wages if they are not in NYC and don't have NYC's cost of living?" The result is that employees and employers are not bound by geography and will move to greener pastures where their quality of life improves. According to CNBC, NYC apartment sales are at a 30-year low, down -54% year-over-year in Q2, and the median sale price has dropped -18% during that time, which indicates that hardly anyone is buying apartments in NYC.[5] We have already seen New York population decreasing even before the pandemic.

The physical constraints of the vertical lifestyle don't work under a government that is trying to enforce social-distancing; and even though COVID-19 may not last forever, it nonetheless creates a lingering impact on our built environment through building codes, government regulation, maintenance requirements, and a cultural change in social norms. We believe COVID-19 marks a turning point for office.

[5] CNBC
https://www.statista.com/chart/22196/manhattan-apartment-sales-coronavirus/

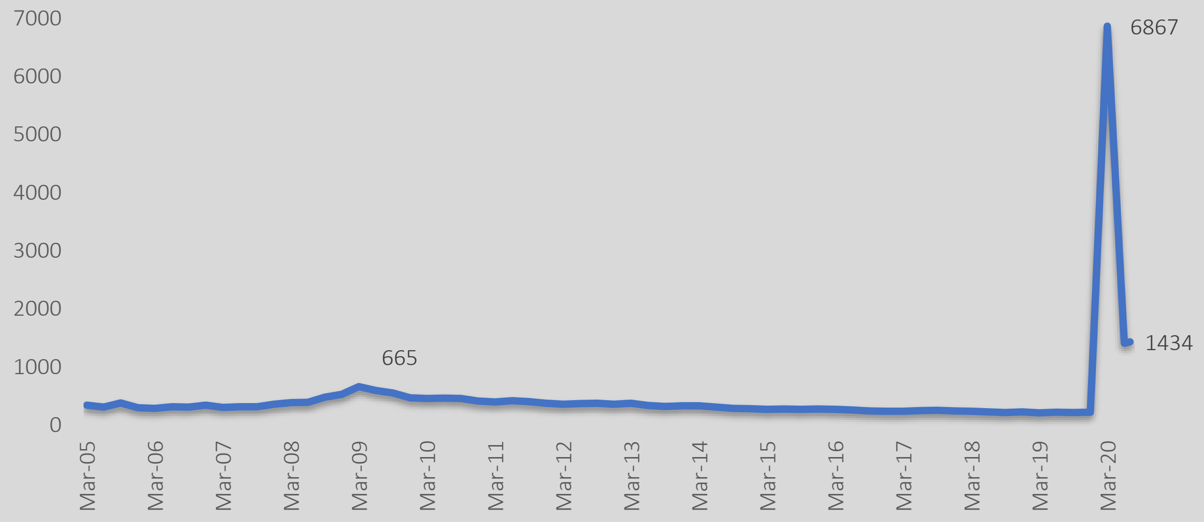
❸Negative Growth in Office Jobs

We are in a bad recession. We have unprecedented layoffs and businesses are facing difficult liquidity issues. We cannot predict how COVID-19 gets fixed or what arbitrary rules the government will force on business tomorrow. What we do know is that companies are not hiring, and this is not good for office landlords.

FIGURE 2

JOBLESS CLAIMS SOAR

US INITIAL JOBLESS CLAIM FILINGS
PER WEEK IN THOUSANDS



Source: Bureau of Labor Statistics

❹Gravitation Towards Lower Cost Environments

Financial and non-financial costs will be a factor in determining winning and losing office markets:

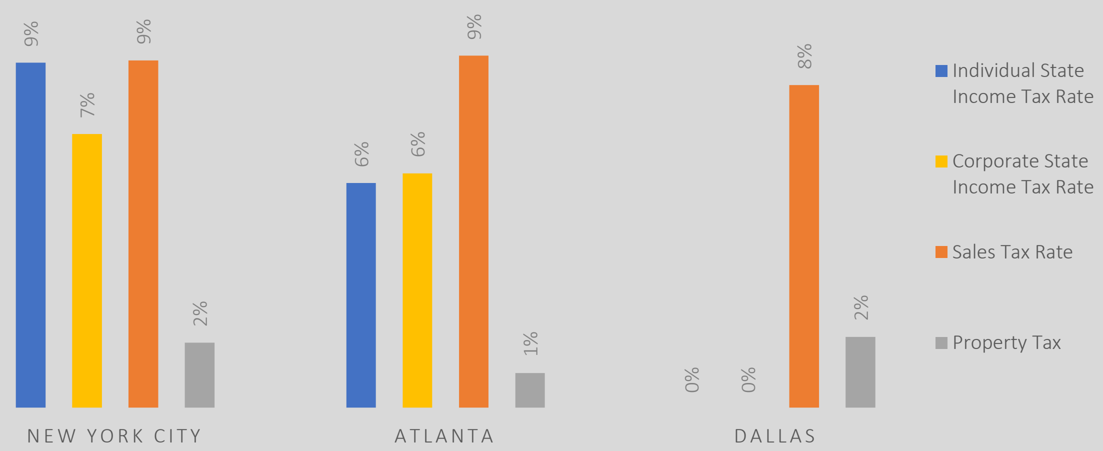
- **Financial Costs:** The states hit hardest by COVID-19 (New York, California, etc.) also have some of the highest tax burdens in the nation for both employers and employees. These states are also running budget deficits, suggesting there will be additional tax hikes in the future to cover the shortfall.

There is already a net domestic migration out of high tax states with more regulation to low-tax states with less regulation, and we believe COVID-19 will only accelerate that trend. Employers and employees fleeing markets like New York may significantly hurt office demand and rents in that market.

FIGURE 3

WORKING SMARTER, NOT HARDER

TAX RATES BY MARKET



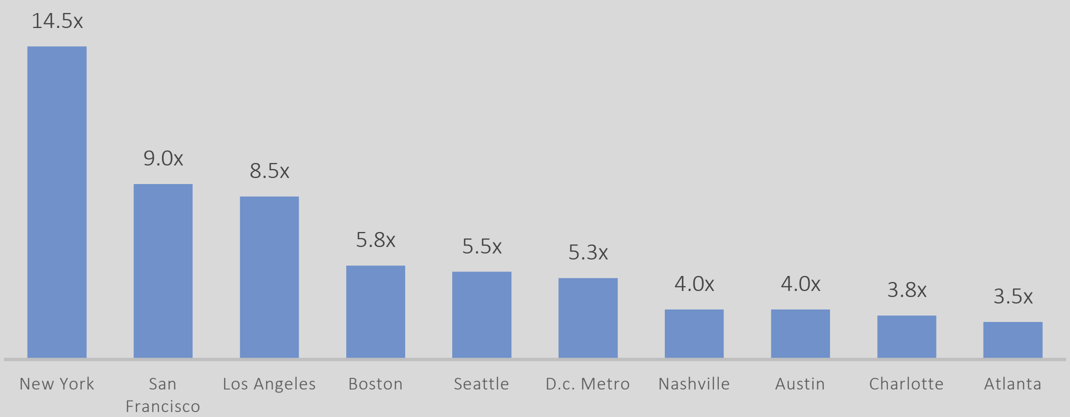
Source: smartassets.com

Home affordability is another financial cost that influences demand for office space. For a company to successfully recruit and retain employees, they must offer them an attractive quality of life, and home affordability is often a big part of that. Currently, homes are about 15x median household income in New York City but less than 4x median household in Atlanta. Going forward, we believe the Sunbelt markets will see much higher job growth and office space demand growth than places like New York City.

FIGURE 4

MORE BANG FOR YOUR BUCK

MEDIAN HOME PRICE TO MEDIAN HOUSEHOLD INCOME RATIO



Source: Greenstreet Advisers as of June 30, 2020

- **Non-Financial Costs:** There are a host of other costs that are difficult to measure but which we intuitively know to be true. Americans generally prefer warmer over colder weather, and over time, we expect the population to migrate from the north and northeast to the Sunbelt. We also expect employees and employers to move to more rural, less regulated locations post-COVID.

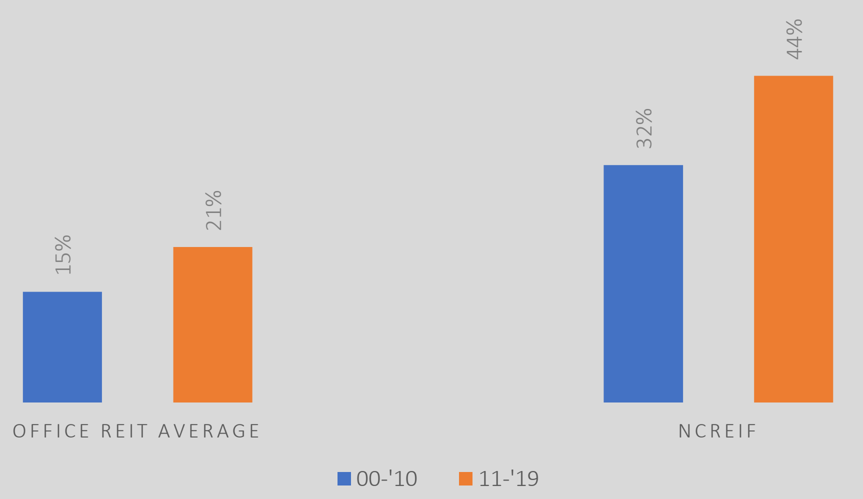
❺Increased Landlord Costs to Retain Tenants Post-COVID

Capital expenditures in the office sector have steadily increased over the past two decades with landlords having to sacrifice more and more to fill vacancy. Office landlord expenses (tenant improvements, lease commissions, social-distancing requirements, and maintenance costs) are poised to further increase in the post-COVID environment as office landlords compete for fewer tenants. We believe this to be true for all types of cities, but especially for “vertical” ones. Green Street Advisers estimates that, in the public market, total CAPEX has increased from 15% to 21% of NOI in the last decade, and NCREIF estimates that CAPEX has increased from 32% to 44% of NOI.[6] This points us to the belief that office landlord profit will be eroded from both sides by declining revenue and increasing costs.

FIGURE 5

DECLINING REVENUE AND INCREASING COSTS FOR OFFICE LANDLORDS

OFFICE TOTAL CAPEX AS A % OF NOI



Source: Green Street Advisors: "Office Insights," June 30, 2020.

[6] GreenStreet Advisers: “Office Insights,” June 30,2020.

Summary of Relative Winners and Losers

The structural shifts of the office sector may benefit certain markets more than others.

⇧ Relative Winners

SUBURBAN/NON-GATEWAY MARKETS

Generally more business-friendly: lower taxes, cheaper labor, lower cost of living, better fiscal health, and less regulation.

Remote workers are no longer tied to gateway markets, and may be able to achieve a comparable quality of life at a lower cost in non-gateway markets.

HIGHER QUALITY, NEWER BUILDINGS

Better amenities/overall building quality may hold up better in weak demand, but all office layouts could be subject to redesign post-COVID.

⇩ Relative Losers

URBAN GATEWAY MARKETS

Generally less business-friendly: higher taxes, more expensive labor, higher costs, worse fiscal health, and more regulation.

Urban markets rely on density and public transportation, which are disrupted by modern social distancing requirements.

LOWER QUALITY, OLDER BUILDINGS

Lower quality buildings will be the first space to go unleased as supply exceeds demand.

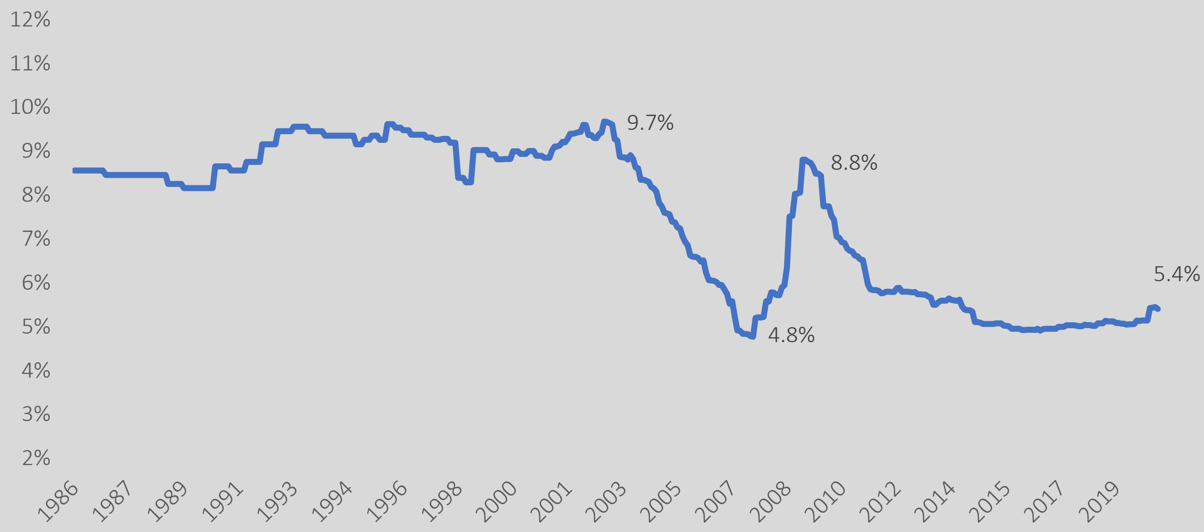
Valuation

You may recall that we always look at valuation last. The first thing we ask ourselves is, “*Is this a good business?*” and the last thing we ask is, “*What is the valuation?”* We have already established that we believe office is a poor sector to invest in, and it also strikes us as expensive given that cap rates are near historical lows.

FIGURE 6

HIGHER CAP RATES, LOWER RETURNS

OFFICE NOMINAL CAP RATE



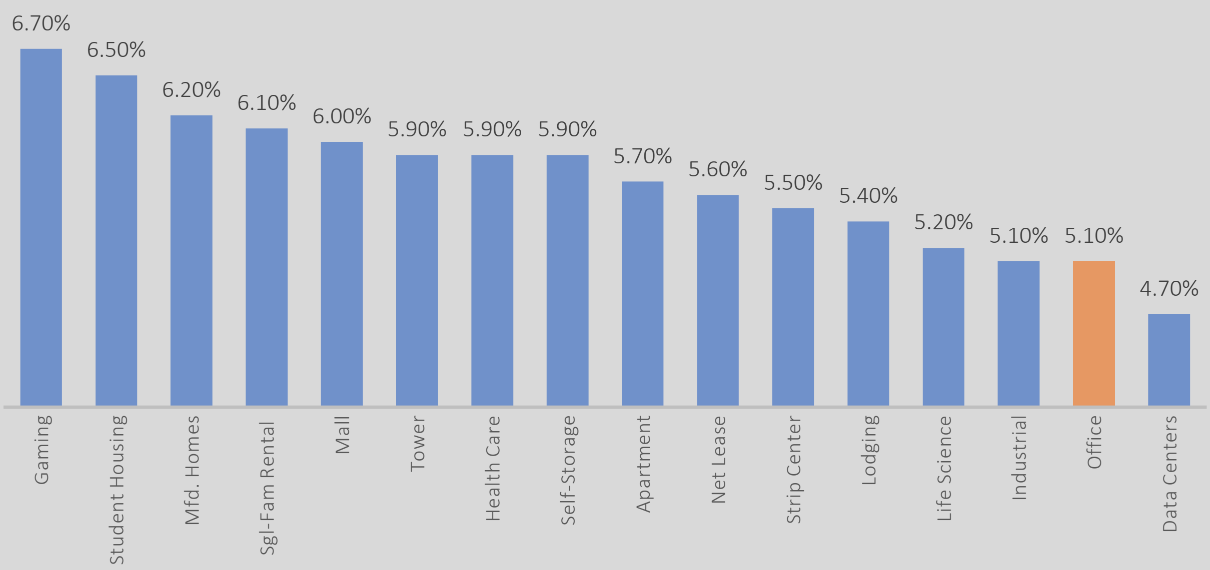
Source: Green Street Advisors as of June 30, 2020.

Relative to other real estate, office is priced to deliver lower returns than other property sectors. We believe the price is too high (and thus the return too low) to fairly compensate investors for the structural headwinds that may impair NOI growth.

FIGURE 7

LOW RETURNS FOR OFFICE

REIT SECTOR EXPECTED RETURNS



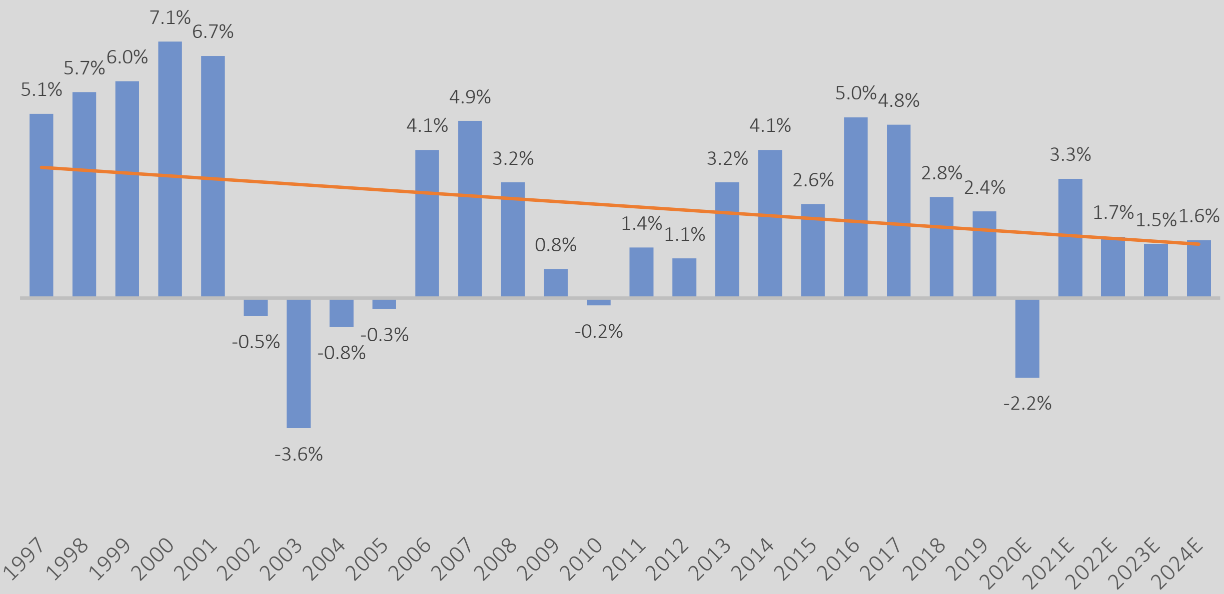
Source: Green Street Advisors as of June 30, 2020.

Same Store Net Operating Income (a measure of income generated from the same space year-over-year) is expected to be lower in the post-COVID era. Notably, the current drop in SSNOI is expected to be worse than it was during the global financial crisis recession.

FIGURE 8

LANDLORD INCOME IN DECLINE

OFFICE SAME STORE NOI GROWTH



Source: Green Street Advisors as of June 30, 2020.

The two main drivers of office valuation are (1) rent collected (net operating income, or "NOI") and (2) required rate of return (cap rate) to discount the NOI. In a hypothetical example, if office rents in NYC were to decline 20% and cap rates were to expand from 5% to 9% (this is the historical range – higher cap rates will be required to compensate investors for the loss of future NOI growth), the office building's value would drop by more than half!

FIGURE 9

NOI AND CAP RATE ARE THE MAIN DRIVERS IN REAL ESTATE VALUATION

A Hypothetical Example

Rent or NOI	Required Rate of Return Cap Rate	Stock Price
BEFORE $1.00	BEFORE 5.0% + 3%-4% *expected future growth*	BEFORE $20.00
AFTER $0.80	AFTER 9.0% + 0%-1% *expected future growth*	AFTER $8.89
RESULT Collected rents drop -20% *Recession, taxes, vacancy, bankruptcies, layoffs*	RESULT Rent growth rates decline, and cap rates increase about 4% *Structural shift to remote working and WFH*	RESULT -56% Drop in office building value ⇩

Source: AACA

A Side Note on Recent Events

Another potential headwind for downtown office space is that crime is rising in the urban core of many gateway cities. According to CNN (on 07/14/2020), homicide rates were up 23% over last year in New York City and up 39% in Chicago during the last week of June and first week of July as compared to last year.[7] We won't venture a guess as to what impact the "defund the police" movement will have, but we assume that any increase in violent crime will likely have a negative impact on demand for commercial real estate space in that market. Crime will be one of the many metrics to keep an eye on in vertical landscapes moving forward.

What AACA is Doing

AACA has long had a 0% position in office real estate. Recall that our focus is investing in companies with portfolios that are as close to monopolies as possible. This is most prevalent when some subset (or all) of these characteristics is present:

1) The sub-sector of real estate is a monopoly, duopoly, or oligopoly
2) There are high barriers to entry for new supply
3) There are high barriers to tenants leaving/exiting buildings
4) The basic underlying economics of the tenant's business is healthy

We have found that when these four characteristics are present, companies in that space can generate favorable same-store net operating income growth over long periods.

In our opinion, office has zero out of these four characteristics. It has (1) thousands of institutional-quality providers, (2) low barriers to new supply, (3) almost no barriers to tenant exit, and (4) negative secular demand.

[7] CNN; https://www.cnn.com/2020/07/14/us/police-violence-defund-debate-trnd/index.html