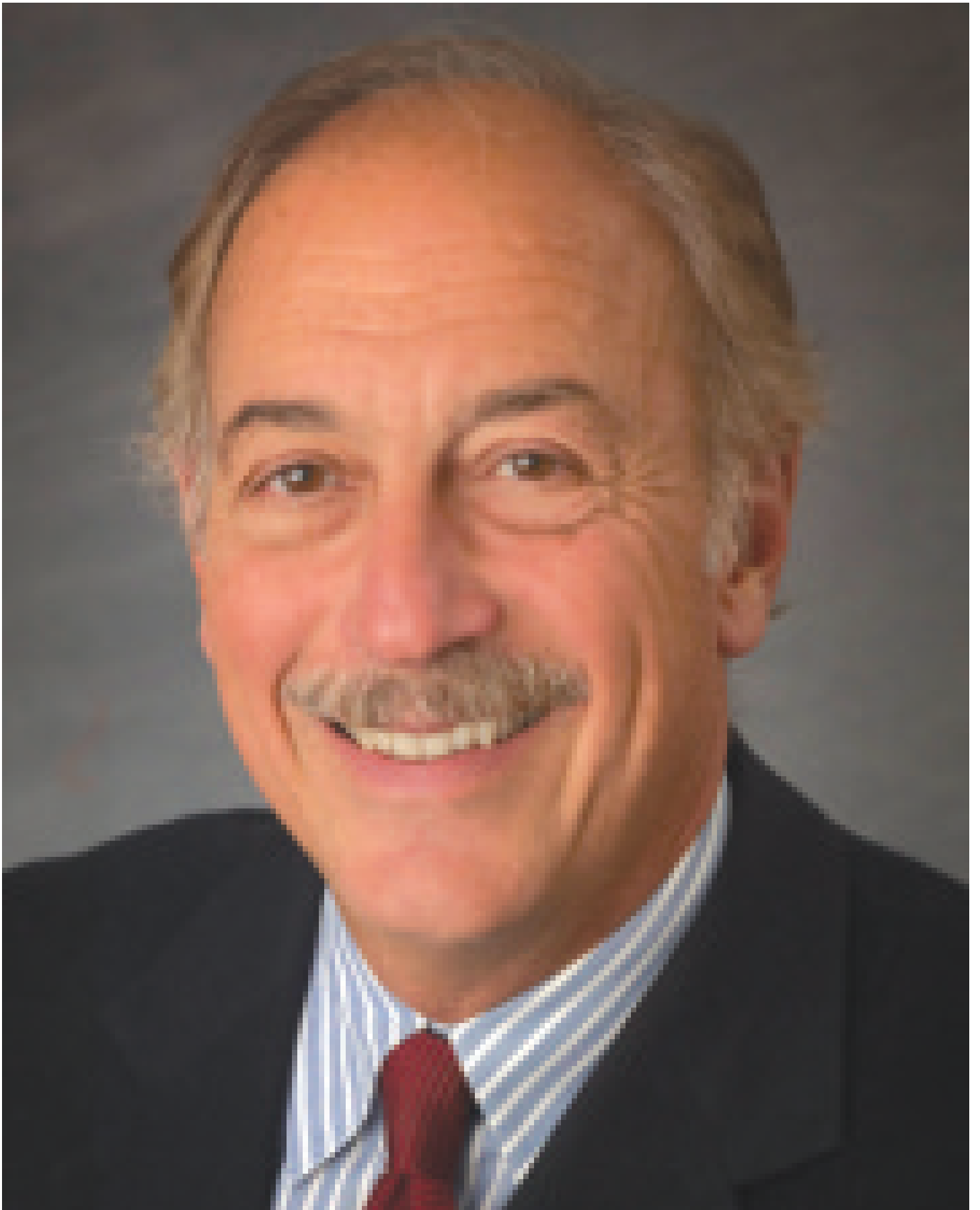




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## **Office space demand slowing: Loan defaults ahead? - by Daniel Calano**

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Everyone, including myself, has opined about when and whether workers would return to the office. In the end, despite some aggressive pressure from employers, a hybrid work style has evolved, typically with employees working from home for two or three days/week, and in the office for the balance. Has the new work structure lowered the needs for commercial office use, or are the employers simply living with it? Well, the facts are in, and the near future is not bright. Demand is clearly down; existing office space is underutilized; and as a result, current leases are very expensive, given the actual square footage being used. The clearest examples are large tech companies which have people who can comfortably work from home, and have no need for extra space, which unfortunately has been recently leased for the future. Ironically, these same companies have recently been pressured to downsized or “right sized” employees in an effort to become more efficient. Based upon their current significantly lower value in the equities market, such companies have laid people off in order to decrease expenses, and have deployed saved labor expenses towards innovation and cloud investments in order to show Wall St. better financials.

This movement, according to recent articles, is most clearly evidenced in tech cities like San Francisco, Seattle, Dallas, Austin, Nashville and so on. While lease data would suggest that vacancy is somewhere around 15 to 20%, actual availability is much higher, in some areas as high as 50% according to a recent WSJ article. As a result, office users like Google and Microsoft, have either subleased their space where possible, or considered not renewing, or in some cases selling leased space.

Beyond the tech heavy cities and companies, randomly, more “regular” firms like J.P. Morgan, Goldman Sachs, Tesla and Home Depot tried to keep workers in their office seats with a mandate for return to the office. This effort failed quickly, and employees either pushed back or quit. If they quit or were fired, they typically have been able to find new jobs within a short time, often at higher pay. But is this the only impact on office? Not at all. At the same time downsizing has been occurring, developers across the country have both been building or planning new office buildings. As we all know, such projects cannot start or stop on a dime. They are started in advance into the face of unknown exogenous events, such as discussed here. Commercial Edge, a real estate analytics firm recently produced a very comprehensive 2022 National Office Report, with a headline saying “weak demand, falling prices and potential distressed activity predict lower values for 2023.” Their data show increase in buildings underway ranges by city from 10 million s/f in Boston (#1), to 7.4 million s/f in Dallas, to 5 million s/f in Washington D.C., with others down below 3 million s/f in cities like Nashville, LA and Denver. Clearly, new construction is building into areas where companies are ironically trying to cut back on space usage. Who’s reading the tea leaves here? Add to lowered demand for office, and potential oversupply of new buildings, are smaller but powerful issues to consider. Technology is constantly improving options like zoom communications, cloud enabled interaction between employees, and while far into the future, AI, or artificial intelligence. These all will have a powerful impact in the future of almost all companies, making them more efficient, and less space intensive.

What are the consequences so far? According to the same Commercial Edge National Report, sales

of commercial buildings have already lowered. With current interest rates already high, and increase in variable rates coming due, and demand by tenants low, the fervor for purchasing buildings has diminished. This is particularly true for class B buildings, which are older, functionally obsolete, and missing amenities more popular in new office buildings. As you have probably read, reuse of the B class buildings as housing is a popular notion, but costs and ultimate products cause this to be difficult. What are the results? Firms are pushing for lower rents. Rollover leases in the next several years may accomplish this, but with obvious impacts on value. Improvements in older buildings may be untenable, due to cost, leading to further deterioration and obsolescence, and unacceptable loan to value ratios. Some loans are already distressed, and some owners may give buildings back to the banks.

It is not hard to do the math, but not a perfect correlation: With 50% availability of space in some of the most prominent areas, net operating incomes will be much lower than anticipated, and which older loans were underwritten, creating obviously problematic future scenarios.

On the bright side, despite all this potential negativity, the US economy is strong, and the future will lead to growth and future need for space. It just probably won't be true in the next few years.

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