The Office Real Estate Market: From COVID Disruption to Uncertain Future

COVID-19 Office U.S. Markets

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The Pre-COVID Decline

Prior to the COVID-19 pandemic, the U.S. office real estate market had been subject to contraction for approximately a decade as businesses tried to lower overhead by implementing various “open office” concepts such as hoteling and/or hot-desking. The results of these methods have been mixed, with prime locations still maintaining their luster while other locations have waned. Companies’ plans for engaging in

hybrid or even full-remote work proved a bridge-too-far for many workers in their efforts to reduce their costs by reducing their office footprint. In spite of these attempts, the average pre-COVID space-per-worker just prior to the pandemic stood at approximately 190 s.f. of office space per worker.

The COVID Disruption

COVID provided the catalyst for the transition from in-person work to hybrid or full-remote work. Office buildings that, before COVID, were fully leased and mostly full on weekdays, sat empty as workers were forced to work from home during the height of the pandemic. Though many businesses have successfully integrated their workers' return to the physical office with full or partial week schedules, it is inevitable that at least some workers will never return to the office and that hybrid work schedules for a significant percentage of office workers may be here to stay. For the tenants that are signing on now, there is evidence that they are asking for even less space-per-worker than prior to the pandemic; with the average being down to 175s.f. of office space per worker.[i]

The nature of most commercial office leases blunted the effect of this COVID work-from-home move, at least for a little while. Typically, most office leases run for terms that can range from three to five years for smaller properties and as many as ten years to fifteen (or more) for larger spaces. Some market locations trend even longer. This time-delay, along with the fact that most of these leases are made as triple-net, has kept many office property owners from feeling the full financial hardships of the pandemic.

As office leases are begin to come to maturity, vacancy rates are rising to a national average of 18.2% throughout most of the nation.[ii] Faced with growing vacancies, office owners are left with only a few options: 1) lower rents in order to preserve current tenants and to entice new tenants to sign on; 2) maintain current rental rates expecting that the office building is attractive enough to lessees that they will eventually come back; 3) make changes to the building; or 4) sell the property at a time when the sale price may not be optimal.

Few office owners will want to be in a position where they must elect option #1, especially as interest rates rise making the cost of debt higher. The last thing most property owners want is a "race to the bottom" for office leasing rates which can depress the market in that area for years. Beyond that, very few owners are in a position where a cut to leasing rates is financially feasible. Office owners' positive cash flows have already been hit by increased property tax burdens (for unleased space), rising maintenance and materials costs, and rising wages for non-management staffing. This can tend to make this an option of last resort for many owners.

Option #2, maintaining or even increasing current rates, unfortunately is only an option for some building owners in limited markets. Certain property owners in especially desirable locations, or with certain marquee tenants who have all in-office operations, have been able to take this option and ride though lease renewals in the past three years without any material hit on their bottom-line.

For most office building owners, option #3 has become the most feasible path forward. Some office buildings can be readily adapted to better fit the needs of potential tenants without serious modifications. For many, the simplest option has been to revise the build-out to accommodate smaller tenants. For others, the layout of the building does not permit this option. For the unluckiest owners the building is approaching (or is at) functional obsolescence in the office market.

Functional Obsolescence

Functional obsolescence exists when there is an issue with the "structure, materials, or design" of a building where those characteristics make the building less marketable than competing buildings in the market.[iii] Most often, this is not purely the result of deferred maintenance or other deterioration of the building due to other factors. Typical factors that can impact whether an office building is becoming functionally obsolete can be items such as inadequate utilities, inability to accommodate preferred tenant build-outs, inaccessibility from the desired workforce (through lack of public transit or being "under-parked" relative to the needs of the tenant's employees), or even just overall poor building design for the expected use.

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What can owners do about it? Well, the first step is to determine whether the obsolescence is “curable” vs. “non-curable”. If spending time and money to cure the item results in an increase of value above the time and money spent on the cure, then generally the issue is curable. If not, or if the issue cannot be corrected in a way that at least maintains the value in the improvement, then the building owner has an incurable case of functional obsolescence.

Curing the obsolescence revolves almost completely around the economic feasibility of the cure. Owners first want to properly identify the cause of the obsolescence to ensure that they are not expending precious capital on fixing the wrong issue. To identify the cause, owners have a few options. They can discuss their issues in securing tenants with knowledgeable brokers who may be able to show them the differences between their property and that of successful owners in the current market. Another option, one that needs to be exercised tactfully and taken with a grain of salt, is to ask potential tenants who have inspected the property, what building characteristics were material factors in them deciding not to lease a building. Either option can lead to important information about the exact issues that are impairing the marketability of a building.

The second step in the process, after identifying the cause, would be to determine the cost to cure which is not just in money spent for the materials and construction of the cure, but also the time and lease interruptions that could be caused by a possible cure. If the costs and the economic disruption that the cure involves exceed the landlord’s ability to effectively manage cash flow, then the cure might not be economically feasible at that time. Rising interest rates, which started the pandemic at 1.5% to 1.75% for the federal funds rate, and had dropped to 0% to .25% a few days into the pandemic, have risen steadily in the last few months to 4.5% to 4.75% as of early February 2023. This greatly increases the costs of borrowing for any large-scale renovations and might prohibit a cure unless the owner has sufficient reserves to perform the cure without borrowing.

<u>Another Path Forward</u>

For owners that cannot cure a property’s functional obsolescence within the office market, what is another option? For some innovative owners, the answer is in changing the building’s use. While not available to all properties, some buildings have gotten a new lease on life by being converted to residential use; some have even found a new life as temporary warehousing space. Converting the building to another use can be a large, expensive and possibly infeasible undertaking for a property owner. What factors should property owners consider when deciding to convert their office buildings? The answer is the same as if the owner was considering a purchase of the property.

First, one should analyze and determine the property’s “highest and best use” consistent with the analysis that would be performed by an appraiser of the building.[iv] This approach begins with an examination of what is reasonably probable by looking at whether that use is physically possible, legally permissible, and financially feasible. While the approach can go much deeper beyond this, at even just a low level of investigation, it makes sense.

As an example, assume you want to convert an office building into luxury apartments. First, you have to determine whether you can divide up the entryways, floors, and other systems to support a format that allows for those apartments. If you cannot, then your idea might not be physically possible. Assuming it is physically possible, you have to look at whether it is legally permissible. Your building may support a build out of those apartments, but your construction will be all for not if residential uses are not permitted in your zone.

This is where the interplay between physically possible and legally permissible comes in. Assuming you can have residential uses in your zone, you have to ask yourself if your building may not have the necessary characteristics to meet the exact zoning requirements. Is the difference between your physical possibilities and your legal requirements something that could be fixed with a visit to the planning board and a resulting variance? A good planner and an experienced land use attorney can help you with that. If the price tag might seem a little steep for their services, remember that it could still be less expensive than the alternative of not meeting the zoning requirements after construction.

When you have figured out whether the property can meet the physical and legal requirements for conversion, you need to look next at the financial feasibility of the conversion. Determining the market for a possible

change in use is critical in understanding whether the whole process is worth it. If the market does not support rates that would reasonably cover the cost of conversion, the project is probably not financially feasible. Given the increasing interest rates, many property owners are now able to afford far fewer capital expenditures than they would have only a few years ago. Further, the increased costs of labor and materials have negatively impacted many building owners' plans to convert their building's use.

Another important factor in determining the financial feasibility of a conversion is the analysis of whether the property tax implications of the conversion have been fully vetted. In most jurisdictions, an under-performing office building is likely assessed (or qualifies to be assessed) at a value lower than a maximally productive building, though that is not always the case.[i] It may be that the office property, with its high vacancy rate and corresponding higher capitalization rate, can qualify for a reduced property tax burden, while it is probable that a newly converted building could be subject to an even higher property tax burden. If the expected difference between the pre-conversion and post-conversion property tax expenses is significant enough, it may not be financially feasible to make the change. This is especially so if the expected property tax burden is high enough that it significantly disrupts the early cash flow for the property. If the increased burden exceeds cash flow after taking into account other financing costs, it is likely that your project is not financially feasible.

All of these factors can complicate the decision to move on from office use. However, there are many building owners that have accomplished their conversion and are in a better financial position for it. Some older construction office buildings that were well beyond the point of functional obsolescence have found new life as high-end apartment buildings. Limited windows, smaller rooms, structural pillars, and all other manner of characteristics that may be making an office building less attractive to businesses, might be making the conversion to residential far easier.

Redevelopment and PILOTS

There may be other incentives available that can make this change easier for a business owner. Some municipalities or authorities have the ability to authorize tax abatements such as "PILOT" (Payments In Lieu Of Taxes) agreements where the municipality or authority can negotiate fixed property tax payments with a lower effective tax rate for the property, often tied to actual income, in return for certain metrics being met or concessions being made. Most common among these concessions is a requirement that a certain percentage of the residential units be set aside for a low-income housing or other "affordable housing" category. Other categories and deals exist and the list of all the types of incentives is too long to list here. For these reasons, it is prudent for a property owner to contact a redevelopment or land use attorney or expert who practices in the region to get an idea of what may be available for a conversion project.

Failing to obtain a PILOT can have complications. One of the larger considerations for a conversion can be the possible property tax impact of the conversion. As noted above, changes to the improvements of a parcel can typically lead to the taxing authority re-evaluating the property value for tax purposes and can cause changes to the assessable value of the parcel for purposes of the tax calculation. In most cases, these changes lead to an increase. In some jurisdictions, these changes can be done outside of the yearly assessment cycle and in other jurisdictions, these changes may be done a year or two retroactive to the change in the parcel's improvements.

Further, one of the greatest benefits most commercial property owners enjoy in their typical leasing agreements, that of being able to pass on some or all of the property tax burden directly onto the tenants (i.e., through triple-net or modified gross leases), is generally not available in residential buildings. While inevitably the property tax burden *is* paid by the residential renters, large increases to property tax assessments may not be immediately recoverable through raising residential rent. Though it varies by jurisdiction, many areas cap residential rate increases in a way that would prevent sharp increases in property tax from being easily incorporated into the rent payments. Anyone seeking to perform a conversion to residential should be fully informed about these issues and should adjust their pre-conversion analysis accordingly.

The decision to perform a conversion from office to residential is a complicated one and should not be taken easily. All the above factors need to be weighed in determining whether the projected net operating income

("NOI") will be sufficiently increased beyond the current NOI as a result of the conversion. If not, a conversion would not be advisable.

The Final Option

The final option alluded to earlier, selling the property, may seem like an option of last resort. However, if costs and other factors have put the owner on the path towards net operating losses or other undesirable financial situations, a sale may be necessary to stave off any future losses.

Rising interest rates may have a negative effect on prices and might make sellers think that they may not be able to get a reasonable return on their sale. However, rising interest rates themselves do not create a novel situation, as rates have been higher many times before. If we look to those times, we can find solutions such as seller financing or other alternate financing options that may help sellers get the return they seek.

Absent the rare buyer that has enough liquid capital to proceed with a purchase without obtaining outside financing, most buyers will need some level of capitalization in order to complete a purchase. Some buyers have sought seller financing to complete or assist with a transaction as a means by which the increased cost of traditional debt can be better managed. While there is certainly a disadvantage to the seller to not having the full balance of the transaction at the completion of the sale, there are advantages the seller may take. First, while it is true that the seller's receipt of the income will be delayed, the seller can also have some deferral of the tax recognition of the sale. This may be advantageous to certain sellers that are structured as pass-through entities or exist in jurisdictions that have graduated tax rates where the yearly limiting of income recognized on the sale may provide a greater net-tax benefit than if the entire sale was recognized in a single tax year.

Finally, IRC 1031 exchanges are still an option if the raising interest rates impact buyer financing. While there is certainly a much smaller pool of buyers that can take advantage of this option, it provides the seller with both the benefit of gaining a new (and hopefully productive) investment property or properties, but also gives the benefit of reduced tax recognition.

Conclusion

All these above options and considerations are difficult factors to consider for landlords of office real estate. Given the changing nature of the post-Covid environment, even more factors may come up as the market re-aligns itself. It is important for the professionals advising these landlords to have given them a full and complete analysis of the opportunities and threats they can be facing in the current market. Helping the landlords successfully navigate this market will pay dividends throughout the nation. And, as is the case with any market correction or market in transition, the challenges faced by current principals of the office market today are likely to present opportunities for others now and in the foreseeable future.

ENDNOTES

[1] Recent reports have suggested that "plunging" office values have reduced ratables for office properties in urban taxing districts to the point where budgetary impacts have already been felt and will continue to grow and cause shortfalls that may cause fiscal pressures and even distress in some cities. *See, e.g.*, Plunging Office Values Costing DC $464M in Tax Revenue | GlobeSt.

[i] Cushman & Wakefield *Marketbeat* U.S. National Office Q4 2022.

[ii] Cushman & Wakefield *Marketbeat* U.S. National Office Q4 2022.

[iii] *The Appraisal of Real Estate, 15th Edition*, Appraisal Institute, pg. 583.

[iv] *The Appraisal of Real Estate, 15th Edition*, Appraisal Institute, pg. 305.
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