HOULIHAN LOKEY

OFFICE MARKET UPDATE

The Impact of COVID-19

Market Update

As working from home is now nearly ubiquitous, tenants and landlords are assessing changes in the office workplace in the new "abnormal normal." Although we are still in early days, some speculate:

- Urban office environments will become less dense to allow for social distancing and increased cleaning;
- Suburban office may come back; more space and shorter commute times means more employee flexibility;
- Intensive renovations of existing office space, increasing airflow, antimicrobial surfaces, and redesigning corridors.

In the short term, office fundamentals remain strong with rent collections maintaining historic levels (so far), however, new leases have slowed and certain tenants are reconsidering their space needs all together. Houlihan Lokey is actively assisting landlords and occupiers to assess the financial impact of these trends.

Rents have held up in Q1 but will likely decline in Q2

- Moody's Analytics' protracted economic slump scenario forecasts national effective rents in 2021 to drop from a pre-COVID-19 forecast of $29 per square foot to a revised estimate of $24 per square foot, coupled with increased vacancy projections from 17.2% to 21.4%.[(1)]
- According to Green Street Advisors, April rent collection averaged 90%, which is higher than earlier estimates. However, many expect this collection rate to drop in May and June as the impact on the office sector has lagged other property types.[(2)]
- Loss of ancillary income (e.g., parking, amenity fees) has also hurt office property owners, with Green Street Advisors estimating 2%–3% additional decline in revenue as a result of these lost sources.[(2)]

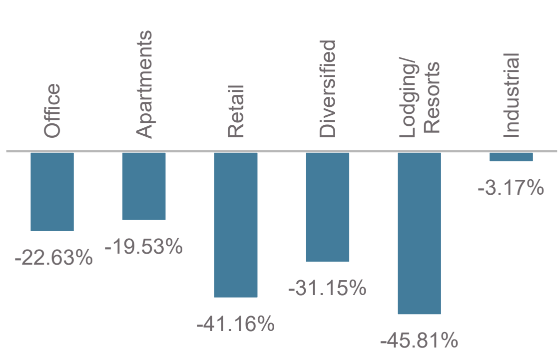
Vacancy rates have increased and are likely to increase materially in coming quarters

- According to CoStar analytics, national office vacancy currently stands at 9.9%. CoStar forecasts that the national vacancy rate will rise over the next year and peak at 12.0% in Q2 2021.[(3)]
- After Q2 2021, CoStar forecasts that national office vacancy will begin to decline and stabilize at around 10% by 2023.[(3)]

Valuations are starting to reflect the COVID-19 impact

- YTD total returns for public office REITs witnessed a 22.63% decline. To the right is a chart comparing YTD public REIT returns by asset type.[(4)]
- As owners assess the impact on their property values, the increased operating expense burden due to increased cleaning, janitorial, and security services is expected to negatively impact property cash flows in the near term, potentially negatively impacting values.
- Green Street Advisors' Commercial Property Index for May 6, 2020, reports an 8% decline[(5)] in office property values over the prior three months.

YTD Relative Returns by Asset Class



Market Update

Transaction volume will likely go down in Q2

- RCA reported that office transaction volume from March 1 to May 8 totaled 130 closed deals, down 57.8% from the same period in 2019.(5)

Leasing activity fell in Q1

- As of May 7, the trailing 12-month national net absorption totaled 34.1 million square feet of office space, approximately 56% lower than CoStar's pre-COVID-19 forecast for this same period.(3)
- Net absorption in Q1 2020 was the lowest since Q1 2013.(3) However, lease renewals increased significantly, as tenants' plans to relocate have dropped in importance compared to urgent near-term liquidity and financial needs.(6)
- CoStar's leasing forecast predicts that net absorption will turn negative in Q2 2020, hitting a trough of -50 million square feet in Q3 2020.(3)
- Although the leasing slowdown is anticipated to rebound in 2021, these declines, coupled with increased construction statistics, may put downward pressure on rents.(3)

Construction starts increased in Q1, but developers are wary

- While closed deals declined year over year, construction starts continued to increase. RCA reported the top-five markets had more than $24 billion in new construction starts during the 12 months ended March 31, 2020. As a result, markets with high levels of construction—such as New York, Boston, San Francisco, and the Washington, D.C./Virginia suburbs—may experience pricing difficulties as the COVID-19 crisis continues.(7)
- In light of anticipated declining demand, certain developers are slowing new construction. For example, in early May 2020, Kilroy Realty Corp. announced a halt to new speculative office developments for at least a year. This slowdown in supply could potentially counteract decreases in leasing activity.(8)

Traditional office space likely to transform post COVID-19

- According to White House guidelines, employers are advised to implement six-feet social distancing rules and conference room capacity limits in offices post COVID-19.(9)
- Kate Listen, president of Global Workplace Analytics, anticipates that 25% of employees will continue to work from home multiple days of the week, up from 4% of people before the pandemic. This will change the desire for space and the type of space needed by office tenants.(10)

COVID-19 puts pressure on coworking tenants

- Flexible office accounts for around 71 million square feet of U.S. office space, concentrated almost entirely in major U.S. metropolitan areas. Coworking tenants are under extreme pressure as membership has heavily decreased during the crisis and substantially slashed coworking tenants revenues.(11)
- Coworking tenants are expected to have a difficult time meeting rent demands in coming months. According to a major developer, only one out of three of its coworking tenants was able to pay rent during the last rent cycle.(8)

Action Items

Revisit **underwriting assumptions**, recasting cash flow forecasts in light of current disruption.

To **generate liquidity**, consider a minority interest or ground lease sale on owned office buildings..

Assess potential for **property tax appeals**, given potential value diminution.

Engage real estate financial professionals to perform expense reduction and monetization analysis.

Perform a detailed **tenant credit analysis** to inform **cash flow projections** and anticipate potential defaults in light of COVID-19 disruptions.

Be **proactive** and opportunistically begin lease renewal discussions and consider strategic portfolio adjustments.

CONTACT US

Houlihan Lokey has a successful track record in assisting its real estate investors and owners through times of extreme volatility and exogenous events.

Please reach out to one of the team members below for more information.

Jeffrey Andrews, MAI
Director
Co-Head of REVS
310.788.5364
JAndrews@HL.com

Michael P. Hedden, MAI, CRE, FRICS
Director
212.497.7936
MHedden@HL.com

Tom Puricelli
Managing Director
Co-Head of REVS
404.495.7026
TPuricelli@HL.com

Additional Contributors: Nick Way, Leo Kao, Bryce Goldsen, and Andrew McLoon.

Sources:

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11. *Protocol, "Can Coworking Survive COVID-19?" (March 26, 2020).*

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HOULIHAN LOKEY

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