BARINGS

REAL ESTATE

Don't be Fooled by Your Office Building Appraisal

INSIGHTS

The sooner investors can recognize that prices in the U.S. office space are not where benchmarks have indicated, the sooner they can move forward with assessing and capitalizing on opportunities in the sector.

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Where are Office Values?

The ambivalence and lag of appraisal-based price indexes are misleading investors over the damage done to their private real estate exposure from rising inflation and interest rates. It is happening at a particularly precarious time for global financial markets. During this particular moment, investors need transparency regarding the values of their holdings. Investment managers have a responsibility to provide as accurate an assessment of current value despite the lack of transactional data points, which are usually sparse during periods of turmoil.

As of the third quarter of 2022, office properties in the NCREIF Property Index (NPI) had posted a total return of 3.2% over the past 12 months, consisting of an income return of 4.3% and an appreciation return of -1.1%. For those investors who own institutional-quality conventional Class A office buildings in almost any major market, this is implausible. Traditional office values are way down. Evidence indicates that space needs and preferences have changed and, as a result, office transaction activity over the past year has once again collapsed while a composite share price index of public office REITs has fallen by more than 30% over the same period.[1]

The U.S. Federal Reserve (Fed) is dealing with broad, persistent inflation unlike anything the nation has experienced in four decades. To restore price and, dare we say it, financial system stability, the Fed cannot follow the same monetary easing playbook as it has since the Global Financial Crisis (GFC). This time, things are necessarily different. Rapid monetary tightening is stressing risk valuations across all risk assets and "yesterday's prices" are not holding up. If asset managers wait for transactions data to draw conclusions about values, they will likely have missed giving their investors information during this critical juncture.

Those who issue and endorse appraisal values should not be the primary arbiters of market values in such moments. Nor do we need a precise understanding of the future path of the office sector. The industry already has abundant information about where values are. At least, we understand where they are not.

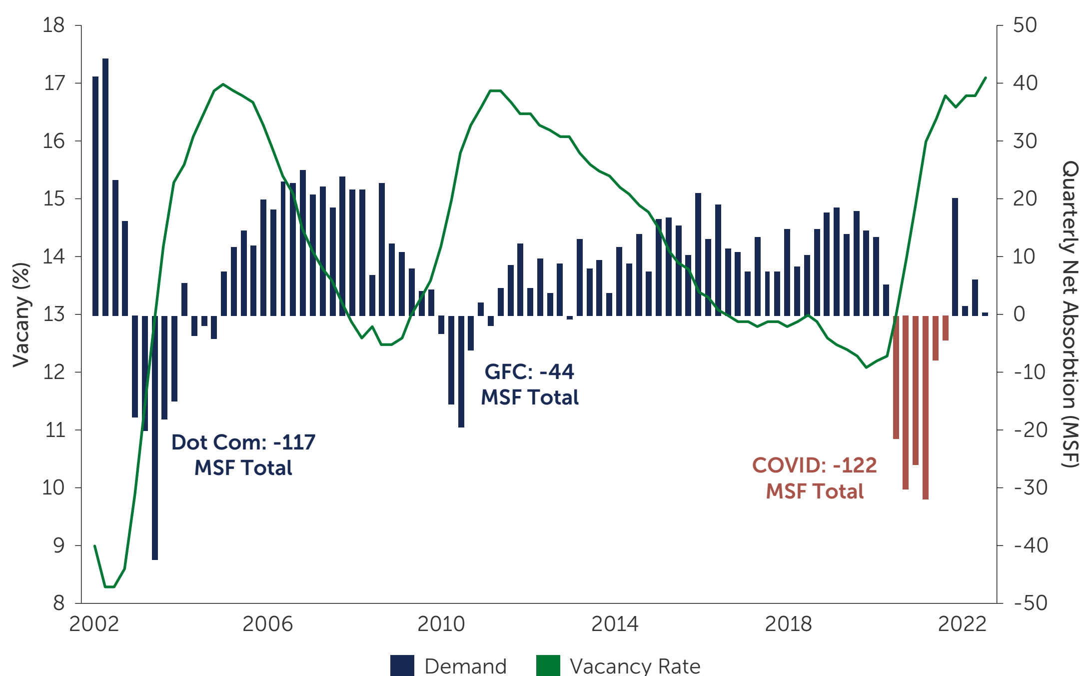
1. Source: Bloomberg. As of September 30, 2022.

The Worst Episode of Demand Destruction on Record

The COVID pandemic has caused office employers to reassess their space needs even as they try to entice employees back to the office. The return to office has been slower than broadly anticipated thanks largely to a historically tight labor market, which has favored employees rather than employers. As of September, the unemployment rate for those with at least a bachelor's degree is 1.8%.[2] Employees have overwhelmingly favored hybrid work arrangements, but the obstacles around returning to office are not only a matter of preference. Challenges around commuting, concerns regarding public health and safety, and the difficulties of finding child and/or eldercare—among a multitude of other factors—have hampered the return to in-office work even for many who otherwise want to go back at least part-time.

From the second quarter of 2020 to the third quarter of 2021, firms in multi-tenant office buildings gave back a cumulative 122 million square feet (MSF) of space **(Figure 1)**. This is the worst episode of demand destruction on record, exceeding the dot-com bust of 2001, when office-using firms gave back 117 MSF of space over nine quarters. However, sublease vacancy, an indicator of office shadow supply, peaked in early 2002, signaling an impending recovery for the market. Today, sublease vacancy continues to climb with few indications of stabilization. Shadow supply—space that is leased or owned but unoccupied—looms large, meaning that vacancy is likely under-represented by top line numbers.

Figure 1: Highest Give-Back of Space on Record



Source: Barings Real Estate. As of June 30, 2022.

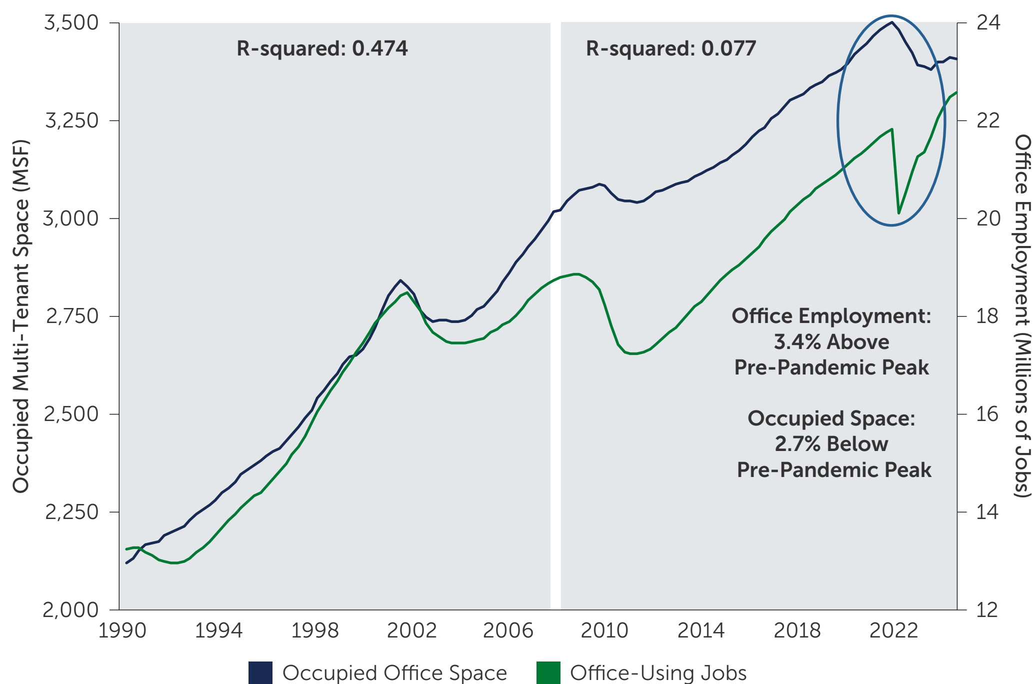
2. Source: Bureau of Labor Statistics. As of September 2022.

Office Demand Decoupling From Employment

Even before the pandemic, the statistical relationship between office employment and occupied office space was weakening. From 1990 to 2007, the regression coefficient (r-squared) between the quarterly change in office-using employment and the change in occupied space was 0.474. From 2007 to 2022, the r-squared dropped to a mere 0.077 **(Figure 2)**. During the intervening years between the GFC and the pandemic, we saw higher densification of office workspaces. There were two primary objectives: to increase the amount of in-person collaboration and to save on space costs. Relative to the impact, an increase in office employment translated into take-up of occupied space from 1990 to 2007—but since then, gains in office jobs have not had meaningful carry over into absorption trends.

Since the pandemic, office-using employment has climbed by 3.4% above its prior peak while occupied space is down from its February 2020 peak by 2.7%, which is likely understated considering shadow space **(Figure 2)**. Some may argue that there hasn't been sufficient time to assess whether the decoupling of office employment and space demand will continue in the post-pandemic era. In reality, the statistical relationship between these trends was already deteriorating well before February 2020. Hybrid work arrangements and accelerating functional obsolescence suggest that conventional office investors should no longer assume that general office employment gains will drive some terminal rate of base demand growth in the post-pandemic era.

Figure 2: Office Employment Growth No Longer a Reliable Indicator of Space Demand



Source: Barings Real Estate. As of June 30, 2022.

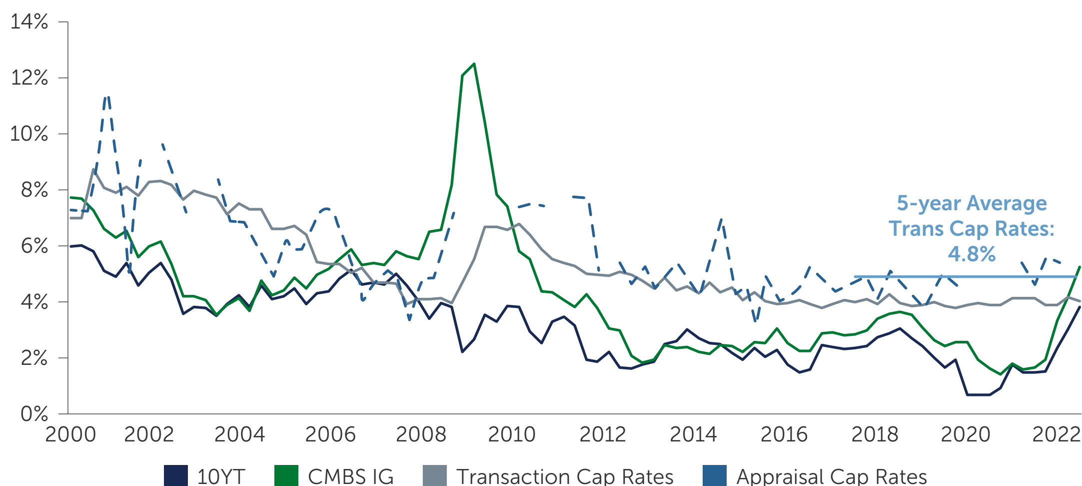
Office Values Hit Harder by Rising Rates Than Other Property Types

Globally, investors have awakened to the risks of a "higher-for-longer" interest rate environment. The speed and degree to which the Fed is hiking rates are the most intense since the 1980s. As a direct consequence, real estate debt costs have risen to their highest in more than a decade. Almost all property types are being repriced in the current environment, but investors are willing to tolerate lower cap rates for sectors, such as industrial, apartment and self-storage, that can benefit from secular demand tailwinds. Apartment and industrial core cap rates have compressed by 63 basis points (bps) and 139 bps, respectively, since the first quarter of 2020 on account of demand prospects **(Figure 3)**. In some cases, cap rates have declined but expected IRRs have stayed level.

Office cap rates have compressed by only 12 bps over the same period. Though low interest rates were a tailwind for office investment, declining demand and rising capital expenditure costs are putting more and more upward pressure on property yields. A "lower-for-longer" interest rate environment permitted a proliferation of office investments that were a "spread play", by which borrowers could leverage thin equity returns due to low borrowing costs. With the Federal Funds Rate set to rise to over 5%, the jump in base rates has resulted in "negative leverage" as property cash flows have remained anemic despite the acceleration in inflation. Even recent transactions, indicated by the dotted line in Figure 3, did not anticipate such a surge in interest rates and financing costs.

Distress within the office sector is increasing while broad market data lags the reality on the ground. Anecdotal evidence of distressed and troubled loans is widening, and loan-to-values that were once considered conservative are being tested as the liquidity and risk profile for office investment deteriorate rapidly.

Figure 3: Appraisal Office Cap Rates Face Reset as Base Rates and Debt Costs Have Spiked



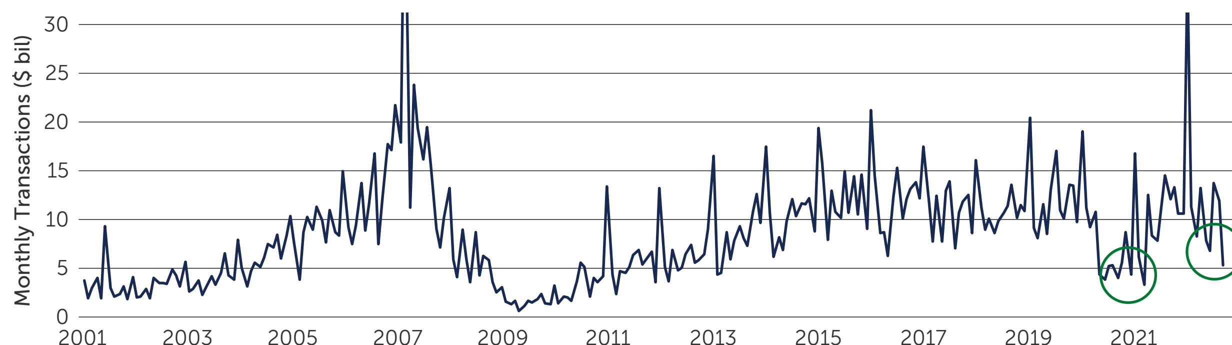
Source: Barings Real Estate. As of September 30, 2022.

Liquidity is Leaving the (Office) Building

Office transaction activity (excluding medical office) in September dropped to $5.7 billion, marking the slowest month for office sales since February 2021 **(Figure 4)**. For the third quarter, office transactions totaled only $19.8 billion, down 43.3% year-over-year and well below the 2015 to 2019 quarterly average of $32.5 billion. Office transaction activity will continue to fall to its pandemic levels as deals closed today were commenced months earlier under more benign capital market circumstances. Sales volume is likely overstating liquidity levels as the uncertainty over the future value of risk assets, not only office properties, is bringing sales activity to a halt.

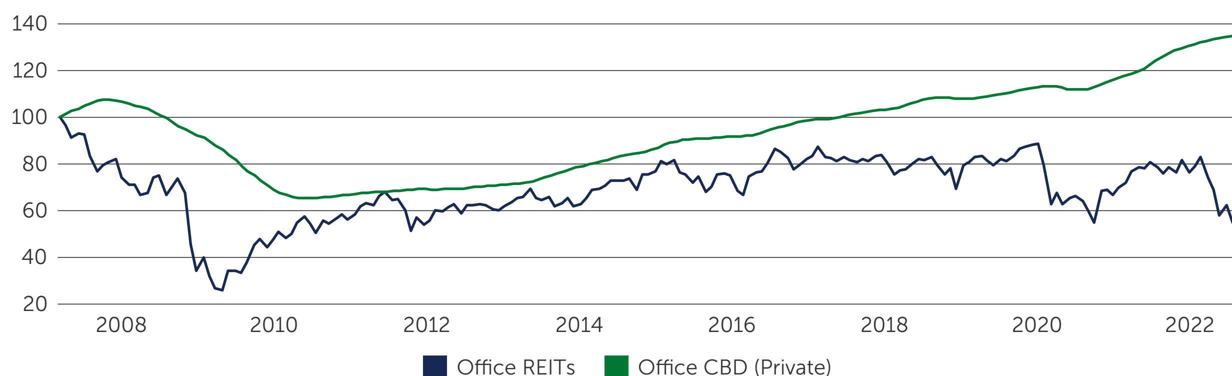
Property price indexes, especially those that are appraisal-based, do not register rapid declines in sales activity. In contrast, public REIT share prices do react to periods of elevated volatility and lower liquidity. They tend to overshoot during moments of pricing dislocation, but public REITs are directionally relevant to private real estate values. During the pandemic, the office subsector component of the FTSE/NAREIT All Equity REIT price index declined by 38.4% from January 2020 to September 2020, but then rebounded by 39.2% over the following 12 months on account of a public sector stimulus-fueled economic rebound. This time around, the office subsector index has fallen by 38.7% under very different capital market circumstances. We think it is reasonable to expect that property values will not emerge from the current market downturn unscathed.

Figure 4: Office Transaction Activity Dropping Back to COVID Lows



Source: Barings. As of June 30, 2022.

Figure 5: Public REITs Have Long Diverged From Property Price Indexes



Source: Barings. As of June 30, 2022.

Is the Office Sector Simply Not Investible?

While the opportunity set of investible offices has dramatically condensed in the post-pandemic era, we believe the property market is bifurcated between the "haves" and "have nots." In a prior article, we explained how those buildings that offer flexible floorplates, collaborative spaces, and substantive ESG implementation among other "next-gen" amenities are increasingly able to attract a disproportionate share of tenant demand—especially if they are located in nodes with a concentration of tech (STEM) firms as well as other amenities. Relative to the "haves", the "have nots" are conventional offices, including unexceptional Class A properties, that have few, if any, distinguishing characteristics.

As firms continue to downsize but move into best-in-class space, investment managers are learning that they are willing to pay up for the office space in locations that will entice their employees to return to the office, and increase in-person interaction and collaboration.

Conclusion

The purpose of this article has not been to pin the blame on commercial real estate appraisers who provide a vital input into the investment decision-making process during normal market conditions. Investment managers who make decisions about when to buy, hold, and sell real estate have a responsibility to provide an accurate assessment of investment values when times are not normal. The office sector is experiencing a perfect storm of declining demand, a fundamental change in tenant space and location preferences, and higher interest rates and financing costs. Future cash flows are also uncertain. We do not know precisely how this current market downturn will play out, but asset managers that have operated and survived past real estate market cycles recognize that values need to account for a worsening macroeconomic outlook, higher degree of functional obsolescence, and the likelihood that interest rates and inflation will be higher going forward than before the pandemic. The sooner we can recognize that prices are not where industry benchmarks have indicated, the sooner we can move forward with assessing and capitalizing on new opportunities within the office sector.

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