AWOL

The economy is coming back, but the people who populate office space are not

by Susan Fornoff

Through the uncertainty of the Great Recession, the turbulence of the financial markets and the agony of a slow recovery, economists and investment managers waited out what they thought would be a predictable cycle for office real estate.

It happens like this: The economy slumps and businesses that have sliced staff cannot dice their real estate because either they own it or they signed 10-year leases. So the square footage per worker spikes even while vacancy rates begin to rise because some businesses close down.

Then, even as the economic recovery gains momentum, vacancy rates stay high but square footage per worker drops as new employees fill the surplus "shadow space" that had gone unoccupied during the recession. Finally, vacancy rates start to drop, rents start to rise, office building construction booms, and all is well in the world of work.

But in the final quarter of 2012 and first quarter of 2013, relief remained AWOL. Vacancy rates were stuck at 17 percent and rents treaded water below the pre-collapse 2008 rates, with

construction at a 14-year low. CoreNet Global, a consortium of businesses including Accenture, Nokia and AT&T, forecasted that planned space per worker will plummet from 225 square feet in 2010 to 151 square feet in 2017. Midway through 2013, a happy ending to the latest office real estate cycle no longer seems inevitable.

Nick Buss, director of North American research for Invesco Real Estate, looked at net absorption in the last two recoveries: "Coming out of the early 1990s, we were absorbing about 16 million square feet on average a quarter, nationally. Coming out of the tech bust in the early part of the last decade, it was about 13 million square feet a quarter. So far, in the 15 quarters of this recovery, we've absorbed a little less than 5 million square feet a quarter … and 50 percent of that has been the tech markets."

Senior economist David Shulman wrote in his December 2012 UCLA Economic Letter: "I am hard pressed to come up with a scenario where office vacancy rates significantly decline over the next few years." After looking at the 2013 employment and office statistics, he concluded, "Other than tech, I do not see any sectors emerging to offset the decline in financial services and legal jobs."

It is not so much just the numbers of employed but the way they are working.

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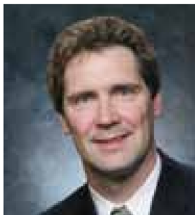
says Andy Warren, director of research for Principal Real Estate Investors. "We're of a mindset that the space-per-worker number is going to continue to get smaller and not only because companies want to cut costs. Today, it's a combination of cost and work process."

It is always about money, of course — and that has not changed.

"The big trend for a number of years now has been to reduce the size of the portfolio," says Tim Venable, vice president for knowledge and research for the business consortium CoreNet Global. CoreNet member Jones Lang LaSalle (JLL) writes in its 2013 survey of corporate real estate executives that 68 percent of respondents report being under pressure to "enhance productivity" of the real estate portfolio.

"The ratio is around 170 square feet per person, and it's continuing to contract," says Bernice Boucher, JLL's head of workplace. "Some of our largest clients are pushing densities closer to 150 square feet per person, and when we did our global real estate survey for this year, 62 percent of companies have increased their space density over the past three years and 72 percent plan to increase their space density over the next three years. So this is not a fad; this is going to continue."

That may be why, Boucher says, her firm is forecasting that vacancy rates may hold at around 15 percent.



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Principal Real Estate Invesors

What is most interesting to Boucher and others, however, is what is going on inside those offices that is making space more efficient. Office space utilization rates have never been at 100 percent, what with vacations, sick days, travel and meetings. But advances in technology have allowed employees to work anywhere they can charge up and connect a laptop and a smart phone. According to the U.S. Census, 10 percent of employees work from home once a week, and one company, Cisco, reports that it saved $277 million a year by encouraging work-at-home policies. Yahoo's widely publicized come-back-to-the-office edict in February notwithstanding, telecommuting has gained acceptance and is widely praised for boosting worker productivity while reducing corporate costs. Accordingly, utilization rates dropped near 50 percent in many offices.

"Executives walk through their offices and see, well, there's a lot of empty space here," Venable says. "There are a lot of workstations that are unoccupied, lots of desks that are not being used. And so companies have been working for years to try to make their portfolios more efficient and to densify their facilities."

Doing more with less

That is not to say that companies are urging their employees home full-time, with some exceptions such as JetBlue's call centers, or even crowding them on top of each other to save real estate. Existing buildings, after all, have only so much plumbing and so many elevators.

Instead, workplace specialists are asking, who needs his or her own office and where? Who really needs a fixed desk or workstation of his or her own? They are clearing out obsolete files and paperwork that can live in the cloud and creating open, collaborative floor plans that encourage teamwork and idea exchanges among employees no longer walled in by a 40-hour workweek.

"I have a file cabinet in my office with files that I've never looked at," Warren says. "How many sheets of paper can you put on the hard drive of a computer now? And how many file cabinets, desk drawers and so forth do we just not need anymore? Principal is in the middle of a $280 million remodel of its campus, and they're creating what they call 'backpack stations' — you walk in with your laptop and your backpack, and you set up there, and that's where you work."

A recent tour of Deloitte's next-generation San Francisco offices, which opened two years ago in a newly leased 182,000-square-foot space, showed how technology can make the workplace of the future feel more spacious even as it is more efficient.

"You can increase your density and use of space as long as you give people the tools, so you don't frustrate the bejesus out of them and make them never want to come into the office," says Tracey Edwards, managing director, global business services and chief knowledge officer. Her office is at 30 Rockefeller in Manhattan, but she checked in to a San Francisco office suite left vacant for the day by the inhabitant whose family photos adorned the desk.

Some Deloitte teams congregate in the D-Café, others use "room wizards" to schedule time in a conference room or "mediascape" room. Rowdy, brainstorming sessions gravitate to the whiteboard-lined "moments that matter" lab — and anyone, anywhere, has the power to

join a meeting remotely via the camera on their company-provided laptop.

Still, on a Friday, the "neighborhoods" of cubicles — now with low walls that allow light to circulate (a top priority among workers and tenants) — had vacancies. Nearly 1,800 workers are "assigned" to the office, but only 650 check in on a typical day.

Location still matters

San Francisco is not one of the markets that concern office real estate market gurus. It is a tech center, and tech and energy have kept top-tier office markets thriving during the recovery.

"It's interesting, if you look at forever and ever, the weakest part of the New York office scene was either downtown or Midtown South, and Midtown South usually took the prize," says Steve Coyle, chief investment officer for Cohen & Steers. "Now the hottest market in Manhattan is Midtown South. And that's because the spaces are old architectural spaces that are appealing to the tech firms. And the tech firms are the ones growing in New York."

Nine technology and energy markets have accounted for nearly 50 percent of the net absorption so far in this recovery, Buss says. In addition to San Francisco and New York City-Midtown South, that includes Austin, Boston, San Jose and Seattle on the tech side, and Denver, Houston and Pittsburgh on the energy side.

"A lot of the bigger markets like Atlanta and Chicago are still bouncing along on a slow, steady recovery process," Buss says. "It's a long haul."

Invesco Real Estate, it must be noted, has been "ratcheting up" its allocation toward office in the past two years, Buss says. "We're of the opinion that we're probably 18 to 24 months ahead of when we think office is going to jump to the head of the pack in terms of producing the highest returns across the different property type sectors."

Principal, too, is seeking opportunity in the market's lag. "The top core office markets that everybody rushed to during the downturn we think are probably kind of peaked out and very expensive right now," Warren says. "We're looking at the next tier — Seattle, Houston, markets like that where the economic activity is a little higher. We still think they're good core markets long term and [are] finding better bargains there where you have a little more upside."

Jones Lang LaSalle reports in its 2013 Cross Sector Survey that investors were most bullish on multifamily property, but office was sitting pretty in second place, ahead of industrial, retail and hotel.

"Price cures a lot of things," Shulman notes. It also does not hurt that new buildings are not standing around empty.

"We've built virtually no space in the last five years," Coyle says. "Construction remains at an all-time low. Construction financing hasn't come back even though the debt markets have come close to roaring back. There's still a dearth of construction financing. So those things are benefits. If we were to be building a significant amount of office space, I think then we'd have real problems."

Words we work by

Remember when "telecommuting" and "offshoring" sounded alarms? Here are some of the terms that have relevance to today's workplace — and, by extension, to today's office real estate investors and developers.

Hoteling: Areas or entire offices where laptop-toting employees use their smart phones or an onsite reservation board to claim a particular workspace for the day. Agilquest's OnBoard system has contributed to raising utilization rates in some workplaces from the U.S. standard of 50 percent to 70–85 percent. Some businesses want to improve on that further.

Desk-sharing: A fixed space or office occupied regularly by the same two — or, sometimes, three — employees.

Heads-down space: Companies embracing today's collaborative, buzzy office design trend have to establish areas where employees can work quietly and without interruption for a few hours, a day or longer.

Touch-down space: The smallest and least personal areas of all, these may consist of little more than a small desk where people who work primarily outside of the workplace can drop in to reconnect with the office and fill out their expense accounts.

Third places: Starbucks, airports, libraries — pretty much anyplace with wi-fi, electrical outlets and chairs.

Re-shoring and near-shoring: Important reversals of the offshoring trend blamed for the loss of domestic jobs in the early 2000s. In a Boston Consulting Group survey in 2012, 37 percent of U.S. companies with sales of more than $1 billion reported they were planning or considering some re-shoring of jobs they had dispatched to countries with cheaper labor or less restrictive employment requirements.

— *Susan Fornoff*

Which is not to say there is not room for new office construction. What tenants want today does not necessarily correspond with what exists. Deloitte, in fact, paid a $12 million penalty to terminate its lease on an older building four years early to move into 100,000 square feet fewer on 10 floors of a newer building.

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Bernice Boucher
Deloitte

"Tenants are looking for more natural light, cleaner air, more control over temperatures, more natural ventilation and operable windows, which you don't see a lot here in the United States," Boucher says. "They want floor plates that lend themselves to creating more open and collaborative space, as well as less noise and the ability to control interruptions. The landlords or developers who are aware of those trends are going to be above the curve when it comes to looking at their inventory of buildings."

Flexibility opens the office door to unconventional uses for some buildings. Two Cohen & Steers buildings in San Jose are attracting nontraditional tenants such as charter schools, for-profit colleges and medical businesses. Warren speculates that healthcare administration and management of the new health insurance exchanges could create office demand during the next decade.

There is no construction boom in sight, no over-demand expected, yet opportunists hold hope that the office is not leaving the building.

"I think you've got to be careful, depending on what market you're in," Buss says, "but I don't believe that 10 years out we're going to need 50 percent less office space than we need today." ❖

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