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Commercial Real Estate: The Office Market in a Post-COVID World

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The pandemic turbocharged e-commerce and work-from-home movements, reshaped the markets, and created winners and losers across commercial real estate sectors. What will this mean for investors? John Murray, PIMCO's global head of private commercial real estate, Francois Trausch, CEO and CIO of Allianz Real Estate, and Megan Walters, who leads global research at Allianz Real Estate, talk with Michael Chandra, who oversees PIMCO's U.S. public client practice. They discuss their market views, particularly within the office sector.

About PIMCO & Allianz Real Estate: PIMCO assumed oversight over Allianz Real Estate in 2020. The partnership combined two organizations with complementary geographic focuses, products, and expertise into one of the largest real estate investors in the world, with $180 billion in assets managed across both public and private real estate[i]. By combining forces, PIMCO and Allianz Real Estate can offer the broad spectrum of real estate investments, ranging from core, stable assets, to opportunistic investments.

Q: BEFORE DIVING INTO YOUR VIEWS ON THE OFFICE SECTOR, FIRST GIVE US A SENSE FOR GLOBAL TRANSACTION VOLUMES IN THE FIRST QUARTER ACROSS VARIOUS REGIONS, AND WHAT ASSET TYPES HELD UP BEST.

Walters: Global transaction volumes fell 26% and 27% in the U.S. and Europe, respectively, and 12% in Asia.[ii] This was not surprising, given the pandemic. Multi-family properties, however, held up incredibly well in the U.S. and Europe. In Europe, the dollar amount of multi-family transactions jumped 66% in the first quarter of 2021 from the year before, with two of the first quarter's biggest deals in residential properties. In Asia, the industrial sector, primarily logistics, performed best, with volumes rising 5% from last year and 22% from 2019. Multi-family was the best-performing sector in terms of transaction volumes in the first quarter in the U.S. Volumes were off just 12% in multi-family; this compares well to retail, down 42%; office, down 36%; and industrial/logistics, off 41%.

Trausch: The disruption from the pandemic has accelerated secular forces such as urbanization. Young people want to live in cities, close to jobs, education, and healthcare. Another trend that has been accelerated is rapid technology adoption, including e-commerce and teleconferencing. Alongside these, the disruption has sent investors in the core and core-plus space looking for quality and stable yields, while seeking to benefit from pandemic-related dislocations. If they cannot find existing core property investments, they are ready to generate yield pickup by "producing" the core (e.g., finding high quality, long-term tenants for a building with little to no deferred maintenance and moderate debt to capitalization).

Murray: I agree, it reshaped the market and created massive dispersion in performance between sectors – more than I've seen in my career – with the winners and losers largely sector specific.

The **hotel** sector has been a short-term loser but should, in our view, recover gradually, albeit unevenly. While the sector is improving dramatically in the U.S., pressures remain in Europe as lockdowns there extended longer. These assets have massive capital shortfalls, which we think are temporary. In the U.S., revenue per available room (RevPAR) has rebounded to roughly 75% of 2019 levels, portending recoveries in Europe as their quarantines are lifted.

In contrast, we believe the **retail** sector is a long-term loser. Retail landlords are suffering along with their tenants and we do not think rescue capital will be enough to save many of these struggling assets. In fact, distress appears set to pick up in 2022. Many tenants are not going to come back or, in the U.S., they will likely vacate when Paycheck Protection Program (PPP) loan funds run out. Adding further pressure is a wall of loan maturities coming due, including for U.S. malls and a wave of core funds looking to reduce retail exposure. In our view, retail is arguably no longer a core portfolio asset. We expect to see opportunities for properties that are being repurposed but only at much lower prices than the previous retail values.

The **industrial sector** has been the big winner, with institutional demand at record highs supported by secular e-commerce tailwinds. Other strong performers include the **residential housing** sector. Longer term, a rise in rates may pressure single-family appreciation. But we expect multifamily-for-rent products to continue benefiting from favorable demographics. One thing to watch in the U.S. rental sector is the numbers of tenants who are unable to pay when stimulus programs end. **Nontraditional residential** sectors such as senior and student housing are seeing growing institutional demand. Lastly, the **office sector** – which we will dive deeper into next – is expected to hold both winners and losers. Tenants aren't defaulting on their leases, even though they are not in the office, but clearly pressures will build as smaller tenant leases rollover.

Q: EMPLOYERS ACROSS THE GLOBE ARE ANNOUNCING RETURN-TO-OFFICE PROGRAMS. WHAT ARE LEASING VOLUMES AND SURVEYS TELLING US?

Walters: Not surprisingly, global leasing volumes are down about 30%. In the U.S., they are even lower, off 45% in the first quarter. More than half of those leases (56%) are renewals. Recent surveys show that the majority of firms, particularly big employers, are waiting until later in the year to decide whether to return to the office full time. Those surveys showed three out of four firms expect about 20% of their employees to work from home two days a week. Interestingly, more than half the firms surveyed expect to increase the amount of floor space per person by as much as 20% for health and hygiene reasons, and to accommodate more collaborative working styles.

Q: BALANCING THE VARIOUS OFFICE SPACE TRENDS, DO YOU THINK FLOOR AREA WILL INCREASE OR DECREASE?

Walters: On average, we believe employers' decisions to offer flextime and to lessen worker density in prime core office space will offset each other; overall prime office space demand will be much less affected by working from home than in secondary office locations and of secondary quality. However, we think companies in traditional workspaces, lined with individual offices, will opt to cut costs – particularly in the next economic downturn – by moving to higher-density open-plan offices that are common in crowded cities like New York, Singapore, and London. These open-floor-plan layouts can shrink needed space by about 20%.

Longer term, the office of the future will not just feature an open floor space, but will likely have a contemporary, event-collaboration or café look and feel.

Q: DOES THE OUTLOOK FOR OFFICE SPACE DEMAND DIFFER BY REGION OR BETWEEN URBAN AND SUBURBAN AREAS?

Walters: Looking at cities around the world, we find that occupancy and rent levels align broadly with population density, rather than gross domestic product (GDP) per capita, as many would assume. In turn, higher-density cities tend to have open-plan offices that can fit more people in the same space. With this in mind, we believe higher-density cities might be more resilient to the work-from-home trend. They've already maximized space with open plans. And if space is given back because businesses fail, there are more alternative users of space in a higher-density city. This asymmetric supply and demand dynamic is marked by a fixed number of very high quality buildings, and many diverse users that might be available to take that space.

Trausch: Asia has the highest-density cities in the world. People are already back at work in Asia and we've seen the office sector perform very well. The growing economy in the region is also contributing to strong demand for office space.

In Europe, the trend toward going back to the office is ongoing. Some cities, like Paris or London, are very dense and already have open office layouts, leaving little room to consolidate space. But in many medium-size cities, there may be a space give-back underway as offices convert to open floor plans. However, unlike Americans and, to some extent, Asians, Europeans do not relocate as often, tending to stay in the city in which they grew up. This provides a floor under the market and a certain level of stability and recurring income, despite the space give-back.

Murray: The U.S. may have the most diverse post-pandemic office space outcomes. Data in major cities like New York and San Francisco is clouded by workers' temporary move out to the suburbs. We are seeing limited tenant defaults. When leases rollover during the next few years, however, we expect to see pressure build in secondary offices with smaller tenants that have not yet de-densified.

Still, there are other relevant trends in the U.S. One is a migration of companies from higher-tax to lower-tax cities like Austin and Dallas. We do not think that it will be cataclysmic for big cities, but it certainly drives demand growth for those relatively small low-tax markets. In addition, some markets have their own set of employment drivers that can offset work-from-home trends. Silicon Valley is one example.

Q: MEGAN, ANY FINAL DEMAND TRENDS THAT YOU'D WANT TO HIGHLIGHT?

Walters: Many large tenants want to be net carbon neutral by 2030. If they want to honor that commitment, the cities they move to will be those with convenient public transport. In addition, achieving carbon neutrality will limit the style of office assets that some of them can occupy. So we think that core prime assets in global gateway cities will do fine, but assets in secondary locations could suffer badly from telecommuting.

We have seen a similar trend in Europe – albeit with different roots – affect retail shopping centers over the last decade. As e-commerce mushroomed, yields between core and secondary shopping centers diverged, with prime core retail doing fine, but secondary performing poorly.

Q: IN LIGHT OF CHANGING OFFICE STYLES, WHAT ARE YOU BUYING IN THE OFFICE SPACE?

Trausch: Allianz Real Estate is a long-term investor, focusing on core (i.e., stable income-generating) long duration, high quality assets, historically in Europe, with growing exposure in the U.S. and Asia. Half of the portfolio is in office investments; the balance is distributed among retail, industrial, residential, and student housing. With that as context, we look for well-located, central office buildings right on the transportation node. Our investment team in Asia has in part concentrated on very visible, central office locations; we recently acquired a 50% participation in one of Singapore's premium office buildings.

High ESG compliance is a prominent theme among investors and tenants. In all the office assets we acquire, we want to see a clear path to reduce carbon footprint. We also seek properties with a positive tenant experience. Tenants want more amenities, and they want more technology in their buildings. Mixed use concepts are popular with retail, offices, and residential. Recent European acquisitions include high-profile complexes in Paris and Belgium.

Q: WHERE ARE YOU FOCUSING IN THE U.S., PARTICULARLY IN THE OPPORTUNISTIC SPACE?

Murray: PIMCO has been active in the higher-yield, shorter-duration, more opportunistic part of the market, including both public and private debt and equity. Our office strategy focuses on the slice of employers that will not offer work from home. For example, we have acquired two vacant office complexes in Silicon Valley in the last nine months. I would argue that Silicon Valley is a heavy research and development market, and much of that cannot be done readily at home and therefore I believe we will see less pressure on those markets. Both office complexes are future-proofed: They are well-positioned for flexible use and potential de-densification. One asset is LEED certified, and we expect the other will be post-redevelopment.

Source for information provided is PIMCO and Allianz Real Estate unless noted otherwise.

i Assets are comprised of PIMCO and Allianz Real Estate Private Equity, Public Equity, Private Debt and Public Debt as of 31 March 2021.

ii Real Capital Analytics

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