Marcus & Millichap Capital Corporation

Cap Alert

LATEST DEBT MARKET INFORMATION

June 26, 2020

Evaluating the Impact of COVID-19 on the Office Market in Cities and Suburbs

Uncertainty continues to be the watchword for commercial real estate investors, as states that had recently reopened experience flare ups in coronavirus infections. Weekly jobless claims held steady at historically high levels, and the outlook for manufacturing rose, with the U.S. purchasing managers index hitting its highest level in four months. After more than three months on lockdown, New York City crept back to life this week, with restaurants offering outdoor seating, retailers inviting shoppers indoors, and offices opening at 50 percent capacity. While Wall Street and legal firms are reportedly bringing up to half of their professionals back to office, many other workers continue to do their jobs remotely for now.

COVID-19 is fueling a massive reassessment of office space by landlords and tenants, who are scrambling to figure out when and how workers will return, and how to best configure their facilities to ensure health and safety. Marcus & Millichap recently released a special report focused on office properties, part of its series "Beyond the Global Health Crisis," and hosted a webinar on the outlook for suburban office assets (click here to watch the replay). Here are three key trends to watch.

Reversing Densification: Over the last decade, high-tech, finance and other companies have clustered in urban downtowns and converted to open-plan offices to foster collaboration, with far less space per employee. That model was beginning to break down as workers found it difficult to focus in communal environments. COVID-19 will likely be the last straw, as tight desk configurations and common areas like kitchens pose new health risks. Some analysts suggest companies may take more office space to allocate additional square footage to each worker and widen hallways; or maintain the same amount of space and de-densify by rotating teams between the office and their homes.

Meanwhile, the energy, social interaction and collaboration of a shared office environment remains important to most workers. A survey by Gensler found only 12 percent of respondents want to work full-time from home. The remainder were equally split between those who prefer to be in the office full-time and those who desire some flexibility. As a result, occupiers may still need to expand. Facebook, for example, has said it needs four times the space per employee, and half of its people will work remote in 10 years. That means in the near-term, the tech giant would still need to double its space, even with only half of its workforce reporting to the office.

Some analysts expect employers to embrace the "hub-and-spoke" model, with urban headquarters surrounded by suburban satellites.

Suburban Opportunity: Watch for a resurgence in suburban office space. "I've never seen a better opportunity or value for suburban office than the situation we are in," said John Chang, National Director of Research for Marcus and Millichap. Sixty percent of Millennials are age 30 and older, and they have been starting families, driving a migration to the suburbs over the last five years. That household growth is likely to accelerate. At the same time, the logistics of commuting to cities on railroads and subways and crowding into elevators in central business districts have become more precarious. Some analysts expect employers to embrace a "hub-and-spoke model," with urban headquarters surrounded by suburban satellites. "The vacancy spread between urban and suburban office has been narrowing for several years but is going to accelerate because of COVID-19," Chang said. "Any occupiers who are on the fence will lean toward the suburbs as leases come up for renewal."

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Reviving Suburban Campuses: Suburban office buildings typically contain larger floorplates, which facilitate social distancing, and ample parking, an important factor as driving to work becomes the preferred commute. At the same time, the nondescript box with a massive asphalt parking field is fading away as employers incorporate more amenities to attract top talent, including outdoor space, restaurants, coffee shops, and fitness facilities.

As landlords and tenants work to find clarity on the future of office utilization, the same is true in the capital markets. Lender demand is less abundant for office than multifamily and industrial, but office is anticipated to be one of the better comeback stories in a year's time. Currently, we see banks, credit unions and some life companies looking at office assets, with intense scrutiny of asset quality, strength and resilience of tenants, rate of collections, and borrower credit. Debt yields and debt coverage are higher, and loan-to-value ratios are lower, at 60 to 65 percent. Rates range from 3.75 to 4.50 percent. CMBS is open to deals but meeting the criteria might be compared to trying to land a 747 aircraft on the head of a pin, with debt yield premiums of 9 percent or more.

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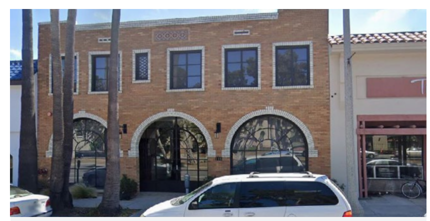
Munster, IN
$5,845,000
4.00% Fixed
5-yr term/25-yr amort.

OFFICE

Beachwood, OH
$3,880,000
2.98% Fixed
5-yr term with 5-yr extension available/25-yr amort.



OFFICE

Redondo Beach, CA
$2,000,000
3.19% Fixed
10-yr term/30-yr amort.
Recourse

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