# Remote work and the future of office space

OCTOBER 2020


## Summary

When office tenants were unexpectedly forced to have their employees work from home (WFH) in March, many were surprised at the productivity they were able to maintain with a remote workforce. This has led real estate investors to rightfully question whether remote work will negatively impact future office absorption. However, we have seen that time and time again, regardless of technological changes and economic cycles, and even in spite of domestic terrorism, both companies and workers are still drawn toward the most dynamic cities, neighborhoods and buildings. The benefits of concentrating intellectual and human capital in such a way cannot be replicated virtually.

So even though many business models are sustainable for the time being, employers are still worried about remote work undermining long-term productivity and, subsequently, future growth. While increased remote work is likely to persist, indications are that most employees will eventually return to the office in some manner. In addition, many tenants massively densified their office spaces over the last cycle and largely avoided speculative leasing, reducing the amount of excess space that can be shed. For those reasons, we believe concerns about a dramatic and permanent reduction in future office demand are overblown. There is no doubt that this downturn will leave lasting changes in the office market – and real estate investors would be wise to understand what that means for asset and market selection – but what is unlikely to change is that leading companies will continue to have employees collaborating together in safe, functional and vibrant workplaces.

In our view, remote work will have a much smaller impact on long-term office absorption than many think.



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## Working from home has had little impact on tenant solvency

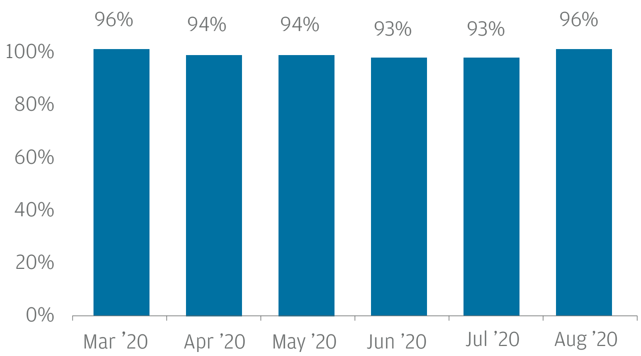
Office market conditions started softening in the first quarter of 2020 as shutdowns first went into effect and then accelerated in the second quarter as large swaths of the country issued shelter-in-place orders. Subsequently, the office market experienced its first quarter of negative net absorption since 2012 and the worst quarter of absorption since 2009, with approximately 21 million square feet given back in the second quarter.

Despite the challenging environment, tenants continue to pay rent. Industry reported collection rates remained in the mid-90s during the worst of the downturn. The majority of delinquencies have come from retail and parking operators in building bases, as well as tenants with business models directly impacted by shutdowns, such as those in the restaurant, retail and travel industries.

Our Real Estate Americas office portfolio, totaling almost 58 million square feet, has collected equally high percentages of its tenant charges, which include base rent and operating expense reimbursements. This is a good indicator of tenant health across a diversified national portfolio of institutional-quality buildings.

**Exhibit 2. Tenant rent collections in line with pre-Covid-19 long-term average**

**Total tenant charges paid**
**JPMAM Real Estate Americas office portfolio**



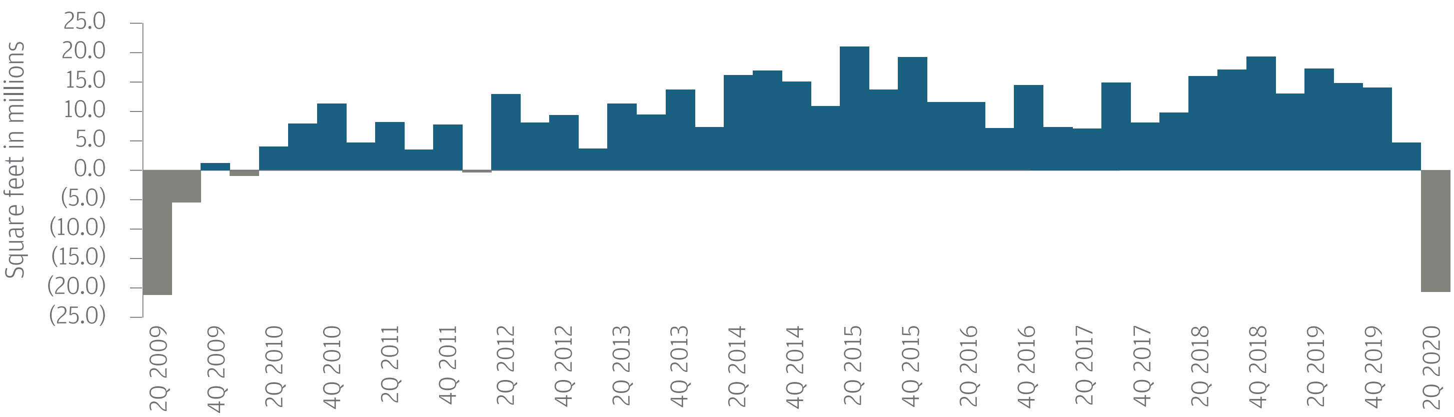

Source: J.P. Morgan Asset Management, as of August 2020.

## WFH has worked temporarily, but employers are concerned about long-term productivity

A key factor driving the success of remote work for many companies is the fact that *all* their workers are remote. As firms begin moving employees back to the office, even with the significant improvements in technology, those who work remotely will see their productivity fall versus those who work in the office. There is always the persistent negative impact of being the person on a screen as opposed to being in a room full of live interactions. Ultimately, it's the critical mass that matters whether remote or in-office.

**Exhibit 1. The office market experienced its first quarter of negative net absorption since 2012**

**Office quarterly net absorption**




Source: CBRE Econometric Advisors, J.P. Morgan Asset Management, as of 2Q 2020.

Even amongst tech companies, which have business models and workforces that are highly suited to remote work, few plan to work from home permanently. Yahoo and IBM are two examples from the past that, in a war for talent with growing competitors, implemented work from anywhere policies. But both eventually reversed those policies after realizing it resulted in poor collaboration and undermined creativity. Today's leading companies may be temporarily working from home for health and safety reasons, but they are just as concerned about it undermining productivity.

Regarding work from home, Netflix CEO Reed Hastings recently told *The Wall Street Journal,* "I don't see any positives. Not being able to get together in person, particularly internationally, is a pure negative." Specifically, Hastings said, "debating ideas is harder now." Expressing both concerns on collaboration but also optimism for the future, Apple CEO Tim Cook remarked during a CBS interview that, "the thing I worry that we'll be missing is the serendipity that we all count on. And for that reason I can't wait until we're all back together again."

## Leading companies are still making commitments to office space

Several of Netflix and Apple's peers have gone beyond simply extoling the virtues of in-office dynamics by making sizeable commitments to new space during this pandemic. Facebook is still clearly focused on providing its workforce with places to gather. In recent months, it signed a 730,000 square foot lease in Midtown Manhattan and is purchasing the 400,000 square foot headquarters of REI, an outdoor recreation retailer, in Bellevue, Washington. The latter deal is in addition to three other neighboring buildings under construction, part of a future million square foot campus in Bellevue's Spring District for the social media giant. Similarly, Amazon has announced office expansions totaling 900,000 square feet across several markets nationwide.

These commitments show that leading firms expect the critical mass of employees to shift back into the office once they can do so safely and responsibly. Lingering health-related concerns may result in staggered office days or other flexible work arrangements, but the majority of workers will still spend most of their time in the office. "If I had to guess," said Netflix's Hastings, "the five-day work week will become four days in the office while one day is virtual from home. I'd bet that's where a lot of companies end up."

## What does partial remote work do to leasing?

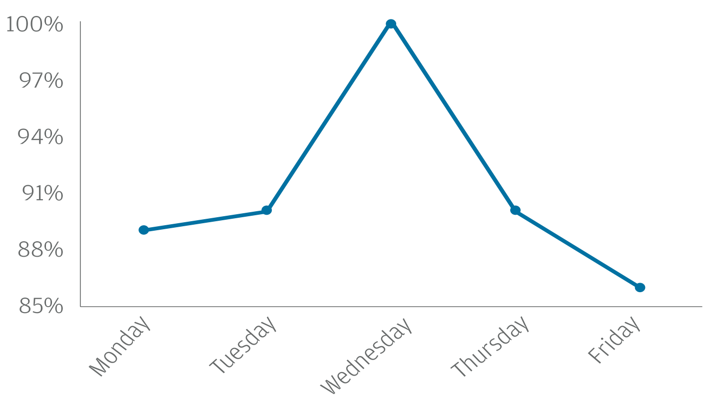
Although we do not believe many employees will move to 100% work from home, partial work from home is inarguably here to stay. But even if companies stagger their workforce so every employee works remotely one day a week, that does not necessarily mean tenants can reduce leased space by 20%.

First of all, workplace utilization across the week was already variable before the 2020 pandemic. Bureau of Labor Statistics work survey data from 2019 showed that people were already in the office roughly 15% less on Fridays than on Wednesdays.

Turnstile entries at Grand Central Terminal in Midtown Manhattan show a similar pattern in commutes in and out of the nation's largest office market. Further staggering of remote work schedules may better distribute the number of in-office workers on any given day, but peak capacity is still important. Just as utilities need generation capacity for the hottest days of the summer and internet bandwidth needs to be sufficient for the hours of the day in which online usage is heaviest, workplaces still need to be sized for days of maximum utilization such as when all-hands meetings and other critical events occur.

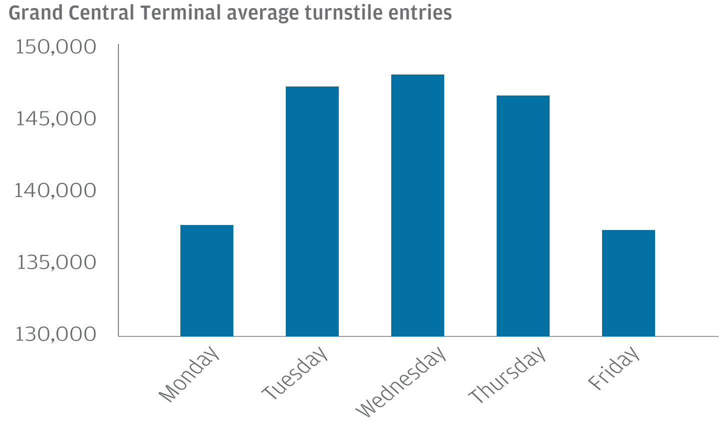
**Exhibit 3. Working in the office was variable even before the pandemic**

**Working at primary work location relative to Wednesday**




Source: American Time Use Survey, Bureau of Labor Statistics, J.P. Morgan Asset Management, as of December 2019.

**Grand Central Terminal average turnstile entries**




Source: New York MTA, J.P. Morgan Asset Management, as of December 2019.

## In-office versus remote work is not a zero sum game: Office work is increasingly what Americans do

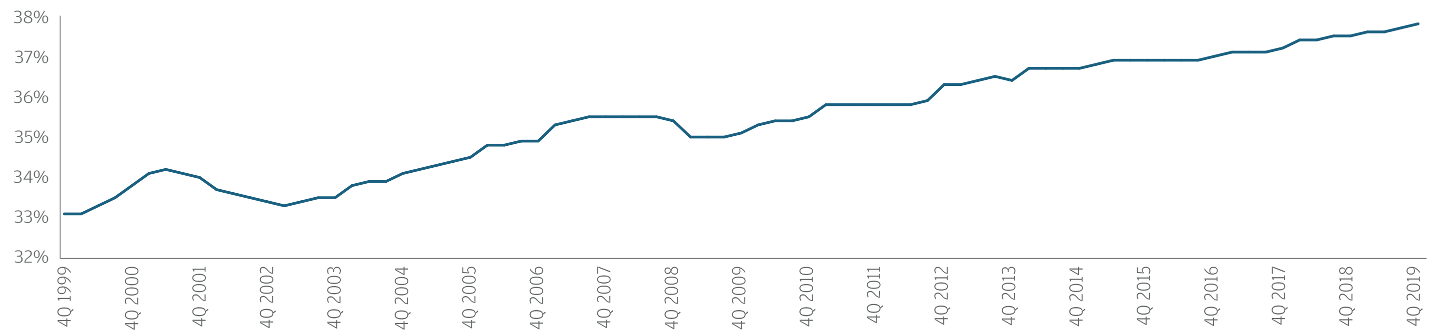
Questions about the future of office demand tend to focus on how to slice the office pie between remote and in-office work. These concerns overlook the fact that the pie is growing. Office-using jobs – in financial services, information and professional and business services – have grown faster than total nonfarm employment over the last five decades as the U.S. economy shifted toward a heavily service-based economy. Not only are American jobs increasingly based in office buildings, but also those jobs are increasingly more productive. While the number of office-using jobs has been rising, the share of private sector wages earned in those jobs has been rising even faster. Growing tenant productivity ultimately leads to a greater ability to pay rents, which is a good thing for landlords.

## Tenants optimized their space needs over the last cycle, minimizing impact of future densification

The office sector of the NCREIF Property Index performed in line with the overall index over the last five years. This is despite the office sector enduring several challenges over the last cycle. After the Global Financial Crisis (GFC), financial and legal services, both major office tenant industries, significantly underperformed the rest of the economy. At the same time, companies putting more workers into ever smaller spaces reduced absorption. This densification trend resulted in weaker office absorption than office job growth after the GFC, whereas the opposite was true in the prior cycle.

**Exhibit 4. American jobs are increasingly based in offices**

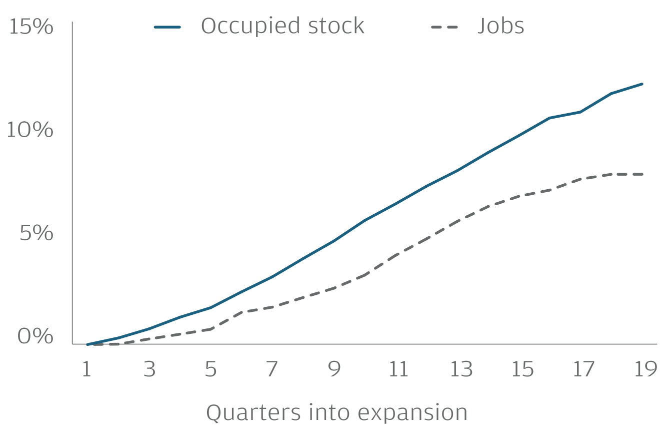
**Share of all U.S. private sector wages earned in office using jobs**




Source: Bureau of Labor Statistics, J.P. Morgan Asset Management, as of 4Q 2020.

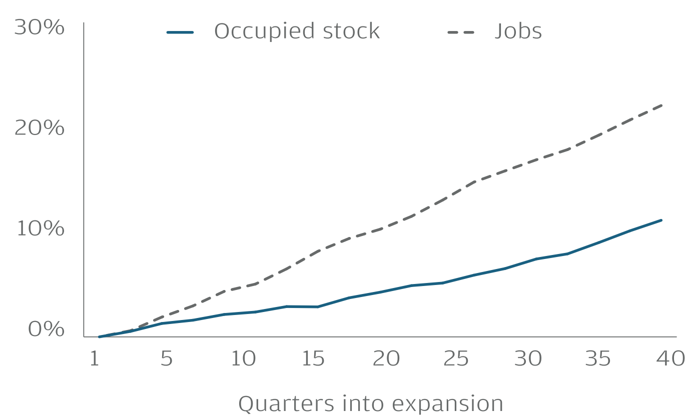
**Exhibit 5. Post-GFC, office densification took hold**

**Pre-GFC: Space grew more than jobs**




Source: Bureau of Labor Statistics, CBRE Econometric Advisors, J.P. Morgan Asset Management, 1Q 2003 to 2Q 2008.

**Post-GFC: Occupied space grew less than jobs**




Source: Bureau of Labor Statistics, CBRE Econometric Advisors, J.P. Morgan Asset Management, 2Q 2010 to 4Q 2019.

The record long economic expansion that preceded the current recession also meant that most tenants have seen leases roll and optimized their space needs within the last business cycle. We are skeptical of a massive re-absorption of space due to permanent social distancing in the workplace, but there was a general sense in the industry – and research to support it – that worker densification had gone too far and was hurting productivity. Moreover, the office market was much less frothy entering 2020 than compared to prior recessions. New deliveries, which unfortunately for office developers tend to peak going into downturns due to long development lead times for this property type, was just 1.4% of stock at the end of 2019 compared to 2.2% and 3.6% of stock heading into the Tech Bust and GFC, respectively.

Similarly, rents tend to pop late in the business cycle. Even though rent growth re-accelerated after the mid-cycle softening of 2016, rents still grew over the last three years at less than half the rate of the run-up to the last two recessions. Manageable new supply and occupancy costs, and tenant spaces mostly modernized in recent years, should help support occupancy levels and mitigate space shedding despite increased work from home.

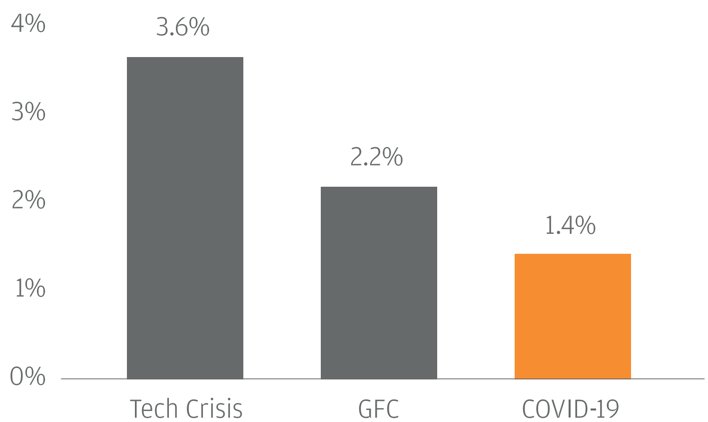
## Post-9/11 case study: Fears over working in urban core was short-lived

Fears about jobs leaving the dense urban markets post-pandemic echo similar concerns about the post-9/11 workplace. For two years after the traumatic events of 9/11, New York City did see its share of regional employment decline. This was partially due to office space destroyed that displaced workers to other parts of the metro area. But some employers also consciously decided to move employees out of the city. Even the most prestigious Wall Street firms made the previously inconceivable move outside of Manhattan, as investment banks built new offices in northern New Jersey and hedge funds decamped to Connecticut.

However, the few years of de-urbanization was followed by a sharp reversal over the next 15 years as jobs re-urbanized back into New York City. Not only did jobs return to the city, but to Manhattan in particular. For example, regardless of booming residential growth, Brooklyn and Queens office markets are still nascent and the center of commercial gravity remains in Manhattan. This phenomenon should be a reminder that regardless of wherever people choose to live, they still tend to prefer working in highly dynamic and concentrated clusters of intellectual capital.

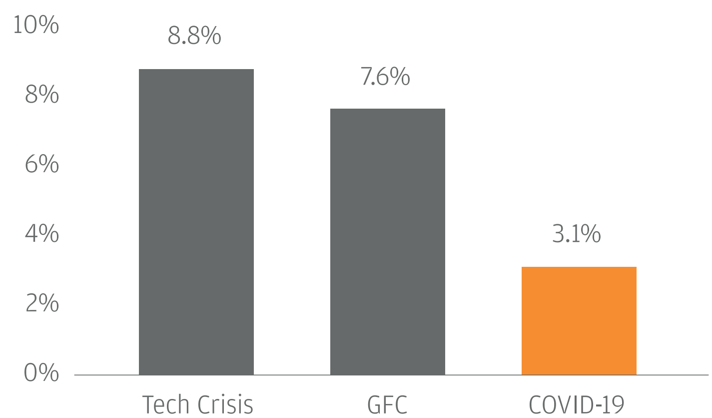
**Exhibit 6. Manageable supply and rents should help support occupancy levels, even with increased WFH**

**Peak deliveries as a % of stock prior to recession**




Source: CBRE Econometric Advisors, J.P. Morgan Asset Management, Pre-Tech Crisis: 4Q 1997 to 4Q 2000 Q4; Pre-GFC: 3Q 2004 to 3Q 2007; Pre-COVID-19: 4Q 2016 to 4Q 2019.

**3-year rent growth compound annual growth rate (CAGR) prior to recession**

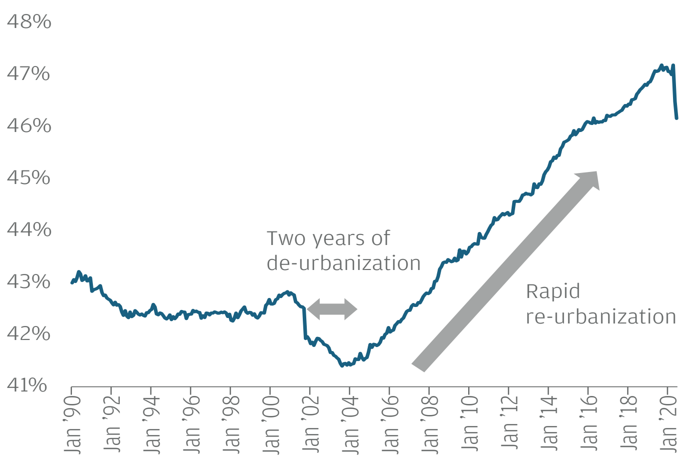



Source: CBRE Econometric Advisors, J.P. Morgan Asset Management, Pre-Tech Crisis: 4Q 1997 to 4Q 2000 Q4; Pre-GFC: 3Q 2004 to 3Q 2007; Pre-COVID-19: 4Q 2016 to 4Q 2019.

The re-urbanization of New York's workforce occurred even though the risk of domestic terrorism still persists, just as COVID-19-related concerns are likely to as well. The infrastructure surrounding how we deal with terrorism remains in place 20 years after 9/11, impacting how New Yorkers utilize public transit and move in and out of buildings, not to mention how the rest of the world manages air travel. But we have adapted to that new normal. Likewise, 17 years after SARS hit much of East Asia, urbanization is growing there as fast as ever.

**Exhibit 7. The re-urbanization of New York City post-9/11**

**Share of New York metro workers employed within New York City**




Source: Bureau of Labor Statistics, J.P. Morgan Asset Management, as of June 2020.

## Conclusion

There is no doubt that the pandemic-induced recession is hurting office along with most other property types right now – but we believe the long-term shifts in office will be evolutionary, not revolutionary. Working from home will likely increase but was not uncommon before the pandemic, meaning many tenants already accounted for some remote work as they optimized office spaces over the last decade. This heavy densification that tenants underwent will make it more difficult to give back large blocks of space in the future. Moreover, the restrained development cycle, in part due to developers acknowledging the headwinds that densification had on absorption, results in office fundamentals being stronger than they were compared to prior recessions.

There will, however, be continued secular shifts in the office market, many of which began pre-COVID-19 and will likely accelerate. The notion of long-term leases subsidized by hefty tenant allowances is neither attractive to tenants nor landlords in times of uncertainty. Tenants may manage for variable space utilization through a mix of long-term and short-term (flex) leasing. The desire for densification, as well as all industries mimicking workplace trends driven by tech and creative companies, disproportionately shifted absorption in recent years toward new construction and redevelopment. This bias toward a more modern office will continue as the type of office environments that allow for efficient floor plates and sufficient light, air, elevator and bathroom capacity are also the environments that are most adaptable toward social distancing in the workplace. For that reason, functionality becomes even more preferable to location, especially if employees will be making fewer commutes or care less about access to public transit.

Lastly, demand is growing rapidly for alternative office uses. The aging population, coupled with rising capital flows into biotech companies working on treating a host of diseases and disorders, has created growing demand for specialized office subtypes such as medical office and lab space. Even though the preferred office assets for the long term may differ from those in the past, serving the most productive workers in the nation's most dynamic places remains a large and viable investment opportunity for real estate investors.

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