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New Trends in Office and Residential Real Estate

About This Column

Resource Center is about all types of information resources that may be helpful for real estate market analysts and valuers. In this edition of Resource Center, we take a look at the latest information and resources on office real estate conversions in the post-pandemic era, plus a new type of residential housing option—build-to-rent developments.

Office Real Estate Market after the COVID-19 Pandemic

The COVID-19 pandemic disrupted the traditional framework of how and where people work, and consequently the office real estate market. The office real estate market—especially central business districts—were developed based on the assumption that workers would congregate in offices. COVID-19 restrictions, however, put that work model on hold. Now, with the health crisis over, there are varying prognostications on the degree to which the centrally assembled office workforce model will be reengaged. Both the timing and the prevalence of return to the traditional model have major implications for all players in the office market—developers, landlords, and tenants. The following resources offer a variety of viewpoints on the office market's strength and future.

"The Office Real Estate Market: From COVID Disruption to Uncertain Future," by Anthony DellaPelle, is one article addressing the major changes in office demand and the office market arising from the pandemic (*Real Estate Issues* 47, no. 10, May 2, 2023, https://bit.ly/3K603qK). The article discusses building functionality and utility, particularly with respect to *functional obsolescence*, a major concern for appraisers of office buildings. The article notes

> Prior to the COVID-19 pandemic, the US office real estate market had been subject to contraction for approximately a decade as businesses tried to lower overhead by implementing various "open office" concepts such as hoteling and/or hot-desking. The results of these methods have been mixed … the average pre-COVID space-per-worker just prior to the pandemic stood at approximately 190 s.f. of office space per worker. … Though many businesses have successfully integrated their workers' return to the physical office with full or partial week schedules, it is inevitable that at least some workers will never return to the office and that hybrid work schedules for a significant percentage of office workers may be here to stay. For the tenants that are signing on now, there is evidence that they are asking for even less space-per-worker than prior to the pandemic; with the average being down to 175 s.f. of office space per worker.[1]
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> As office leases are begin[ning] to come to maturity, vacancy rates are rising to a national average of 18.2% throughout most of the nation.[2] Faced with growing vacancies, office owners are left with only a few options: (1) lower rents in order to preserve current tenants and to entice new tenants to sign on; (2) maintain current rental rates expecting that the office building is attractive enough to lessees that they will eventually come back; (3) make changes to the building; or (4) sell the property at a time when the sale price may not be optimal.

1. The article cites Cushman & Wakefield, *Marketbeat: US National Office Q4 2022*.
2. Cushman & Wakefield, *Marketbeat: US Office Q4 2022.*

The office market for tenants and investors depends heavily on how the appraised property relates to developing newer market standards, norms, and expectations. A building not meeting market standards likely has functional obsolescence. If not economically feasible to cure the deficiency, then conversion to another use, or repurposing, must be considered based on market demand for an alternative use, physical possibility, and legal permissibility (may be public and private considerations) as well as a cost-benefit analysis.

Propmodo presents several discussions on the post-pandemic office market. An April 2023 article, **"Opening the Doors: Measuring the Return to the Office,"** by Courtney Porcella (https://bit.ly/3Yn97xz), helps in understanding the post-COVID office changes. This commentary observes, "US offices hit a notable milestone in January as the never-ending return to work saga continues: for the first time since 2019, weekly average occupancy exceeded 50 percent of pre-pandemic levels according to Kastle access data. … Even before COVID-19 crept into the world, most occupancy estimates hovered around 75-85 percent at best."

Propmodo also offers an informative video covering **"Calculating Office Utilization"** (https://bit.ly/3YokBku), which should be of interest to those involved in analysis of office functionality and utility, as well as office building consulting, appraising, and analysis.

Related office market analytical tools are addressed in the June 2023 article **"4 Atypical Ways Investors Are Looking at the Office Market"** by Holly Dutton (https://bit.ly/442FByf). This article cautions that while various data reports "come out quarterly, sometimes even monthly, and offer a useful snapshot of fundamentals like office vacancy rates, leasing and sales volume, and often a breakdown of activity in submarkets …. in today's complicated economic landscape, it helps to look at other sources and take a more thorough approach." The article goes on to address supplementary analysis of office markets, which consider foot traffic (not just for retail), cellphone usage,[3] badge swipes, venture capital funding, and job-posting data.

Another Propmodo piece discusses how some office buildings have one or more tenants offering co-working space. Approaches for valuing co-working spaces in office buildings is addressed in the May 2023 article **"Real Estate Professionals Are Adopting New Approaches for Valuing Co-Working Spaces"** by Holly Dutton (https://bit.ly/3DNh1XJ). The article notes that after the pandemic accelerated remote work trends, "large corporate occupiers saw carving out space for co-working as a smart component of their overall office strategy." This, however, presents the question of how it's valued within the context of an office building.

> Flexible office space ….means that the real estate industry, and the lenders that service them, are becoming more savvy in the way they underwrite these spaces….
>
> There's no question that co-working and flex spaces can be harder to value and are often looked at as riskier, but there are instances where these kinds of spaces can end up being more favorable than traditional office space. … Co-working operators may not have been the most desirable tenant in the past and may even be the last tenant of choice now, but a lot of office owners would rather have a building occupied than manage through vacancy. …And as advances in technology continue to grow and better support virtual collaboration, it underscores how much value flex space provides to the office market.

3. A June 20, 2023, *Wall Street Journal* article, "Wall Street Sours on America's Downtowns," by Heather Gillers, notes cellphone activity (and its change over time) is another factor for assessing the health of downtowns.

A third Propmodo article by Holly Dutton, **"Single-Use Office Campuses Face Subleasing Conundrum,"** December 2022 (https://bit.ly/3KxcgVG), comments that "available sublease space is hitting all-time highs, some companies that built all-in-one corporate campuses sequestered away from central business districts and high-traffic areas are finding themselves with extra space and a lot of competition to fill." Several examples of such situations and cases are cited and discussed.

The office sector flight to quality is a consequence of the difficult office market for investors. The office market is, in most urban markets, suffering from low occupancy and valuation challenges. But there are some silver linings in some geographic areas for some office types and submarkets. This is addressed in a June 2023 Propmodo piece, **"The Data behind the Office Sector's Flight-to-Quality,"** by Barbra Murray (https://bit.ly/3KBk7l8). Here, in the opinion of many, if not most, the general office sector is apparently some distance from a rebound—except for the high-end segment, trophy, signature, and Class A properties.[4]

A June 2023 Propmodo piece, **"Higher Office Sales Volume Doesn't Always Mean Higher Leasing Volume"** (https://bit.ly/3qp7FhG), observes that "office vacancy and occupancy rates are often discussed when assessing the health of office markets. However, comparing office sales to office leasing can also provide interesting perspectives. Office sales, similar to leasing volume, have shown a decline in recent months. … When comparing cities' sales volume numbers to leasing figures, there's an uneven correlation." For example, Chicago has the second highest leasing volume but is fifth in terms of sales.

Office Conversions: Market Changes and Repurposing Improved Properties

Challenges in Repurposing Office Buildings

Repurposing or converting an office building to an alternative, more in-demand use may represent the highest and best use, and may be the use motivating a buyer. The challenges are important considerations for appraisers, however, as they evaluate the highest and best use of existing office buildings.

A Propmodo article on the subject, **"Many Office Buildings Can't Be Repurposed due to Excessive Tension,"** by Franco Faraudo (https://bit.ly/44fgQz3), notes that the housing shortage leads "most people to the obvious conclusion that we should repurpose office buildings into apartments and condos. …But, as good of an idea as it sounds, there are many reasons why this will not work for most office buildings."

Two May 2023 articles discuss the significant challenges of office conversions. **"5 Reasons Why Office-to-Residential Conversions Are a Serious Challenge,"** by Ben Abramson, Strong Towns (https://bit.ly/3DWPgvI), lists some major obstacles to residential conversions: deep floor plates with no natural light; need to reconfigure plumbing, HVAC, and windows; and expensive construction of typical residential amenities and attractive residential aesthetic. **"Office-to-Residential Conversions Are Not the Magic Bullet Many Think They Are"** (https://bit.ly/3QJpdjs) further focuses on the difficulties of office space conversions.

> Converting office buildings into residential units is a painstaking process that involves some serious architectural gymnastics… To convert these buildings into apartments, developers must divide these large spaces into smaller units, often requiring significant modifications to the structure and layout of the building.

4. In contrast, a *Wall Street Journal* article in March 2023, "Distress in Office Market Spreads to High-End Buildings" (https://bit.ly/3s59PDE), suggested that amenities provided an advantage for occupancy levels earlier in the pandemic for office buildings, but vacancies later rose with interest rates.

Non-Residential Alternative Uses of Office Buildings

The physical and legal problems encountered can make a conversion to residential use extremely expensive—often keeping it from being economically feasible.

A Propmodo article notes, however, that office conversions are not limited to residential alternative use. **"Vacant Office Buildings Are Being Converted for Non-Housing Purposes Too"** (https://bit.ly/44gUzAO) addresses repurposing of office properties for a variety of nonresidential uses that may make more economic, physical, and market sense, such as conversions to hotel, lab, self-storage, retail, education uses, or event space. Another Propmodo article, **"Owners Are Getting Creative with Vacant Office Conversions"** (https://bit.ly/3QP9dfs), also addressing alternative repurposing, states,

> Aside from the most common conversions of office to residential and industrial, … companies [are] repurposing unused office space into storage, small gyms, co-working space, and even micro-schools. … Cities with high office vacancy rates…are launching incentive programs to help owners and developers make the transition. But it is still a niche strategy in the real estate industry that is constrained by a number of factors, including regulatory barriers, construction costs, and simply not having the right infrastructure to support a major change.

Depending on the location, life science uses are sometimes a possibility for office building conversions; this depends on physical, legal, economic, and market feasibility. Among the benefits of life science conversion is a shortened timeline for occupancy. New construction of a life science development typically requires 3–5 years, while conversion projects may take only 1–2 years. In addition, life science assets provide the landlord with more money than standard office leases—rent growth in this sector has significantly outpaced that of office buildings for over five years.[5]

But life science costs of conversion are high, as discussed in **"What Makes a Good Life Sciences Real Estate Conversion?,"** Propmodo (https://bit.ly/3E0GYTD). This article notes "it can cost twice or even three times as much to fit out typical office space to install the necessary plumbing, ventilation, clean rooms, loading docks, and other specialized needs. …In general, life science buildings require more storage to account for chemical storage and hazardous waste disposal. …ample shipping and loading zones…. backup generators and ventilation and fire suppression systems."

Despite these issues, the life science property sector has seen record growth that is expected to continue. For more on this sector, see discussions in **"The Emergent Biomanufacturing Ecosystem Will Launch a New Era of Real Estate Investment,"** Propmodo (https://bit.ly/3qDDweI), and **"After 'Odd Year' for Life Sciences, What's Next?,"** Propmodo (https://bit.ly/45evzeP).

Economics and Trends Impacting the Office Market

Appraisers might be interested in learning more about the factors that have contributed to the current situation of office properties.

Interest rates. A *Wall Street Journal* article, **"Rising Interest Rates Threaten to Expose Office Buildings' Inflated Values"** (October 31, 2022), observes that "cheap debt fueled a decadelong boom in US office values, offsetting the impact of years of rent increases that didn't keep pace with inflation. Now that the long period of easy credit

5. A CBRE report shows that in the twelve largest US life science markets, lab and life science lease rates increased by an average of 11% in 2021. Meanwhile, office lease rates in those same markets only increased by 2%. "San Francisco Bay Area Second Largest Percentage Gain in Life Sciences Conversions" (https://bit.ly/45zuEFw).

is over, office-building owners are bracing to see how much less their properties are actually worth." Another *Wall Street Journal* article, **"America's Office Glut Started Decades before the Pandemic"** (August 23, 2022), describes how the office sector was struggling with soft demand long before COVID-19 and how low interest rates masked those problems, pushing values to record highs even as rents fell.

> Between 1997 and the end of 2021, effective office rents…in the 50 biggest US markets fell by 16%, adjusted for inflation, according to data from Moody's Analytics. And yet office-building values rose by an inflation-adjusted 91% during that period.

Since the COVID pandemic, particularly with the 2022–2023 interest rate increases, the relatively high prices (compared to effective rent) have come down markedly, with vacancies continuing to climb in most markets. Conversely, we are now seeing the effect of increasing interest rates, and occupancy problems, on the office investment market and office values.

Fewer workers in offices. The current state of office properties is also related to the shift away from workforce density in central locations. *The Wall Street Journal* has a number of articles looking at the gloomy prospects related to this trend. One piece, **"Wall Street Sours on America's Downtown"** (June 20, 2023), points out "on average, offices in major metro areas have half as many workers compared with before the pandemic." Another article, **"The Return to the Office Has Stalled"** (May 16, 2023), reports data demonstrating this new reality: "Office buildings are only about 50% as full as before COVID-19 across 10 major metro areas, according to keycard tracking by Kastle Systems, a building-security company. Federal transit data show public-transportation ridership at less than 70% of pre-COVID levels in major metro areas." An earlier article, **"Office Vacancies Send Real Estate Investors for the Exits"** (April 6, 2023), said, "Now, with white-collar workers spending more time in their home offices, a phenomenon that shows few signs of ending, investments linked to downtowns are trading at falling prices in volatile markets." As one "indication of investor worries, those who buy a common type of low-rated commercial mortgage-backed security are demanding 9.25 percentage points more interest than that on 10-year Treasury Bonds [as of June 12, 2023] according to research from Bank of America. This spread is three times as big as before the pandemic for such securities, which finance a property mix that is around 30% office space."

In general, real estate investment trusts (REITS) holding downtown real estate have not been favored by investors, particularly since the 2020–2021 COVID era. Commercial mortgage-backed securities' (CMBS) price and yield levels vary according to returns from alternative investments (e.g., Treasuries and corporate bonds), perceived risk, and market outlook. Keeping that in mind, *The Wall Street Journal* reported in **"Distress in Office Market Spreads to High-End Buildings"** (March 28, 2023) that

> a small corner of the US bond market, so-called commercial mortgage-backed securities, or CMBS, have taken a beating for over a year owing to fears that owners of business parks, high-rises and other office properties could default on loans extended at a time of different work habits and lower financing costs. Prices of bonds backed by commercial mortgages have recently dropped to levels not seen since the early days of the pandemic, pointing to a growing economic threat stemming from office vacancies and rising interest rates.

In *Real Estate Issues*, **"The Office Market Reckoning Is Nigh"** by Andrew Nelson (47, no. 12, May 8, 2023; https://bit.ly/45SyXw7) also looks at "the impact that reduced office tenant demand has on property capital markets." It reports that the return to office debate "is largely settled: workers won't be sitting at their company desks nearly as often as before the pandemic." The article points out that firms and workers are leaving the top 6 markets (New York, Chicago, Washington, San Francisco, Boston, and Los Angeles), and vacancy rates have soared in these markets. The author notes "already property values have fallen more in the office sector than in any other property sector, while investment returns have been the lowest. And that pain will only intensify as market conditions weaken further."

The author points out that tenant demand and occupancy dropped significantly after the pandemic, as have rents, sale prices, transaction volume, and absorption. He notes, however, that in 2022 the drop was muted for several reasons; among them, firms were in medium to long-term leases and thought they would need the space later, and office-using parts of the economy had fewer layoffs (except tech grew). The vacancy rate is expected to rise as leases expire and firms reduce space. "The best indication of future leasing intentions is the amount of unused space firms are making available for sublease. Colliers estimates that sublease availability has doubled from pre-pandemic levels to almost 250 million square feet. …Most of that space will eventually be counted as vacant landlord space once the leases roll from the tenants' responsibility. Thus, expect vacancy rates to spike over the next two years." The author also notes that "in a stunning reversal of fortune, office demand is shifting away from downtown markets, especially in the dominant office market as vacancies rose higher and faster in downtown markets than in suburban markets. …This shift is the opposite of what usually occurs after market downturns, when tenants leverage falling rents to trade up from commodity suburban space to more desirable downtown offices."

Further, the author discusses changes in capitalization rates, falling values, REITS returns by property sector (comparing office returns to other sectors such as industrial, residential, health care, etc.), and changing capital markets. Over a dozen citations and endnotes document the points made and provide the reader with additional resources.

In the same issue of *Real Estate Issues* readers will find **"Evolving the Office Space: How Commercial Spaces Are Adapting for Hybrid Employees"** (https://bit.ly/45f6el6). This piece speaks to changing standards for office functionality[6] with design considering hybrid employees working some days from home and some days in the office. "Hybrid models present an excellent middle ground for those wanting time at home but also needing time in the office. Flexibility is a priority for many job seekers in today's economy. In fact, a McKinsey study reveals 87% of workers accept opportunities to work in a flexible format. This format is popular because employees have more autonomy over their schedule, workstations and daily workflow." A 2022 Gallup survey reported in **"The Advantages and Challenges of Hybrid Work** (https://bit.ly/3KJnxm0) explores the benefits of hybrid work as it rises in the United States and worldwide as "hybrid working is the new normal." To bridge the gap between in-office and remote workplaces, office design has become "resimercial," which introduces residential elements into the office space. To learn more about this office trend, read **"The Rise of Resimercial Design in the Workplace"** (April 2022, https://bit.ly/47ARNJF).

Digging Deeper

Appraisers can access a wealth of additional information about office markets and office properties by visiting the websites of stakeholder organizations. On the next page, you'll find a listing of some of these organizations as well as niche information related to design trends and obsolescence.

6. Remember, functionality and design are important to appraisers as they must consider functional obsolescence points in all approaches. The appraised functionality of the appraised property is compared to market standards, which change with the times.

Additional Office Market Resources

Professional Associations

Several major professional and trade organizations involved with office building development and management are valuable resources for appraisers needing information related to the office sector market. The following seven are among the most well-known and respected commercial real estate organizations.

1. **Building Owners and Managers Association (BOMA) International**—a primary source of information on office building development, leasing, building operating costs, sustainability, local and national building codes, legislation, occupancy statistics, and technological developments. (www.boma.org)
2. **CCIM Institute (CCIM)**—a commercial real estate professional organization providing opportunities through its education program. (CCIM.com)
3. **National Association of Realtors (NAR)**—America's largest trade association representing members involved in all aspects of the residential and commercial real estate industries. (www.nar.realtor)
4. **NAIOP, the Commercial Real Estate Development Association**—an organization for developers, owners, and related professionals in office, industrial, and mixed-use real estate. (www.naiop.org/research-and-publications/)
5. **Society of Industrial and Office Realtors (SIOR)**—research and publications including *SIOR Report* and SIOR Pulse Blog. (www.sior.com)
6. **US Green Building Council (USGBC)**—topical articles and research. (www.usgbc.org/)
7. **Institute of Real Estate Management (IREM)**. (www.irem.org and www.irem.org/publications)

For names and descriptions of additional organizations, see "List of Top Commercial Real Estate Associations," https://bit.ly/3QFIm5G.

Office Design Trends

Design trends may be of importance for appraisers and others considering the extent of functional obsolescence in an office property. Here are some resources that may have publications, periodical writings, and research papers of interest to office appraisers.

- **Allwork.Space "2023 Future of Work Forecast: Office Design Is Ever-Evolving; Here Are 5 Trends for 2023."** This report discusses (1) net zero buildings, (2) solidifying how hybrid and remote work will shape physical office space, (3) data-driven design strategies, (4) multi-modal design, and (5) greenwashing, as well as additional related topics and writings. (https://bit.ly/3YE5svu)
- **"Office Trends 2023: Top 10 Popular Ideas and Design Concepts."** Looks at designed aimed at improving productivity and efficiency. (https://mydecortrends.com/office-trends/)
- **"7 Commercial Office Design Trends for 2023."** Looks at approaches to open-concept workspaces. (www.dgicommunications.com/commercial-office-design/)
- **"Office Design Trends in 2023."** Addresses hybrid work spaces, collaborative spaces, natural light, energy efficiency, "smart" offices and technology, and amenities to retain employees. (www.iofficecorp.com/blog/office-design-trends-2023/)
- **"Modern Office Design: Features and Trends in 2023."** Highlights differences between modern and traditional office design as well as the latest trends. (https://foyr.com/learn/modern-office-design-features-and-trends/)

The Build-to-Rent Market

The post-COVID era has also seen changes in the residential real estate market. There has been notable interest in single-family built-for-rent housing developments in response to problems with housing shortages and affordability. A December 2022 ManageCasa.com article, **"Built to Rent Housing Market Exploding,"** pointed to the lack of options for affordable housing as the impetus for interest in build-to-rent housing (https://bit.ly/47B9cBY).

More recently, a July 2023 *Real Estate Issues* article, **"Build-to-Rent Homes: A Promising Solution to Chronic Housing Shortages,"** observed that "when homeownership is increasingly out of reach for many, build-to-rent (BTR) housing offers a desirable alternative to traditional homeownership. First, BTRs provide flexibility that traditional homeownership cannot match. … Second, BTRs are often built to higher standards than traditional rental properties, ... And third, BTRs offer a high-quality home without homeownership mortgage and maintenance obligations….Where available, BTRs are quickly becoming a preferred option for many young families, empty-nesters, and itinerant retirees. Yet several local governments … have enacted laws banning BTR developments." The article addresses the importance of innovative housing, zoning, bias, and exclusion (https://bit.ly/45dneat).

The National Association of Home Builders (NAHB) reports that "with the onset of the Great Recession and declines for the homeownership rate, the share of built-for-rent homes increased in the years after the recession. While the market share of single-family built-for-rent homes is small, it has clearly expanded. Given affordability challenges in the for-sale market, the SFBFR market will likely retain an elevated market share as the sector cools." However, NAHB also reports that during the 2023 second quarter there was a slight decline in single-family built-for-rent (https://bit.ly/3P2WEMo).

In February 2021, *Forbes* reported on **"Build-to-Rent (BTR): Detached Housing and the Future of Multifamily"** (https://bit.ly/47G77EI). Since this was published, BTRs have grown in many communities in the United States. The article points to the benefits of such developments:

> The real innovation in the build-to-rent space lies in the improved experience for tenants. BTR provides tenants with all of the best aspects of single-family rentals and upgrades the experience by developing all homes inside a professionally managed, amenity-rich community all without burdening residents with HOA costs….
>
> BTR properties have broad appeal. They are simultaneously attractive to seniors, singles and families.

Those unfamiliar with this residential sector might want to start by reading CBRE's **"Build-to-Rent (BTR) Overview,"** especially its "Introduction to Build-to-Rent" (June 12, 2023, https://bit.ly/3P1GbqP). The article states

> BTR developments are new residential communities, increasing US housing supply and helping to address the nation's housing shortage. BTR communities have the characteristics of single-family homes, built for renters desiring features not typically offered with multifamily properties.
>
> Most BTR properties consist of 50 or more homes or townhomes and operate similarly to multifamily assets. A defining characteristic of BTR is that nobody lives above or below residents. BTR properties are owned by investors and professionally managed, often with community amenities.

The discussion provides information about the various types of BTR, such as horizontal attached or detached homes, two-story townhomes, cottages, traditional detached single family, and upscale luxury single family. It goes on to provide information about differences between BTR and "scattered SFR" for individual and institutional investors. Further, this piece has worthy exhibits covering such material as average mortgage payment vs. rent; housing surplus and shortage; housing unit shortages in four regions of the country; premium paid to own vs. rent for US and over 20 metro areas; and other statistics and comparisons helpful to the market analyst including apartment vs. BTR vacancy; average apartment rent vs. BTR rent; BTR vs. apartment growth rates 2013 through 2022; the 15 largest BTR markets; alternative methods of investing in BTR; and related insights.

A number of articles provide information from the investor and renter perspectives. Rocket Mortgage offers **"Build-to-Rent Homes: A Renter's and Investor's Guide to a Hot Real Estate Trend"** (April 2023, https://bit.ly/3P31ut6). This writing provides extensive information on the topic as well as pros and cons for renters, buyers, and investors. Another Rocket Mortgage piece, **"Everything You Need to Know about Rent-to-Own Homes"** (August 2023, https://bit.ly/3KRbhjp), explains the pros and cons of these arrangements. This gets into lease-option agreements, lease-purchase agreements, characteristics, provisions, features, cautions with each, and conclusions. Similarly, the Redfin blog offers advice in **"Build-to-Rent Homes: What You Need to Know about the Future of Single-Family Rentals"** (August 2022, https://bit.ly/45BirjY). Topics include motivations and role of developers, individuals, and investors; reasons for popularity and growth; pros and cons for tenants, individuals, and investors; investment alternatives; and ADUs as an option.

Forbes's January 2023 forecast on the sector, **"'Built-for-Rent' Single-Family Housing Forecast: Easing in 2023 and Booming in 2024/2025"** (https://bit.ly/3qBiNIf), states, "When considering the outlook for this segment, which is universally regarded as one of the strongest segments of real estate, it is important to look both short-term and long-term. Here we consider both horizons."

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