The COVID-19 Pandemic Will Reshape The U.S. Office Sector

Thomas Feltmate, Senior Economist | 416-944-5730
Admir Kolaj, Economist | 416-944-6318

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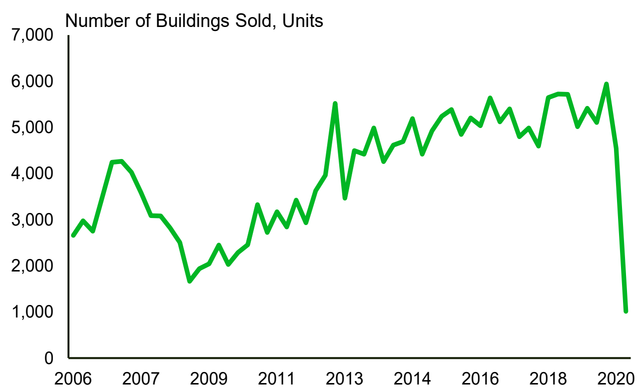
Highlights

- The full effects of the coronavirus outbreak on the U.S. CRE sector remain somewhat unclear, though it is widely expected that we will see a sharp near-term pullback in new leasing and transaction volume through the remainder of 2020. This is particularly true for the office segment.
- Looking across the major eastern metropolitan areas, New York, Boston and Miami are likely the most exposed to the downturn, given their current elevated supply pipelines. New York is also highly exposed to the co-working space, which has come under serious pressure of late.
- Outside of the near-term, COVID-19 is also expected to have more lasting impacts on the demand for office space, as it helps to accelerate trends that have long been in the works well before the health crisis. Teleworking appears to be the biggest culprit, especially across those working in information, finance activities and professional & business services. Looking ahead, many companies and their employees may opt for a blended approach of work from home and time in the office.
- For the many jobs that remain in an office setting, reconfigured spaces aimed at reducing worker density are likely to provide some offset on demand for space from increased teleworking. However, traditional office hubs in major metropolitan centers are likely to become less popular, as companies move to more fragmented satellite offices located outside of the downtown core.

The near-term impacts of COVID-19 have been well covered by economists over the last several months. While certainly helpful for the 'here and now', we also need to start thinking about how COVID-19 will reshape industries once the pandemic subsides. At the heart of the discussion lies the commercial real estate sector, whose landscape is bound to see changes as the ground beneath shifts over the coming years. Through a series of papers, we hope to highlight some of the potential risks across the various CRE segments. In this piece, we focus on the office segment and address the question "How will COVID-19 reshape the demand for office space?".

Our findings suggest that COVID-19 will likely lead to slower growth in office demand, as it helps to accelerate trends that were already in the works even before the health crisis began. Teleworking appears to be the biggest culprit, particularly across information, financial activities and professional & business services, where a growing share of the workforce had already been working from home. Technological advancements such as in voice recognition, automation and artificial intelligence, meanwhile, will continue to reduce the need for some business support services (i.e. travel and reservation services, online content reviewers etc.), leading to reduced demand for office space. At the same time, the potential for

Chart 1: COVID-19 Deals Massive Blow to Near-term Office Sales



Source: CoStar, TD Economics

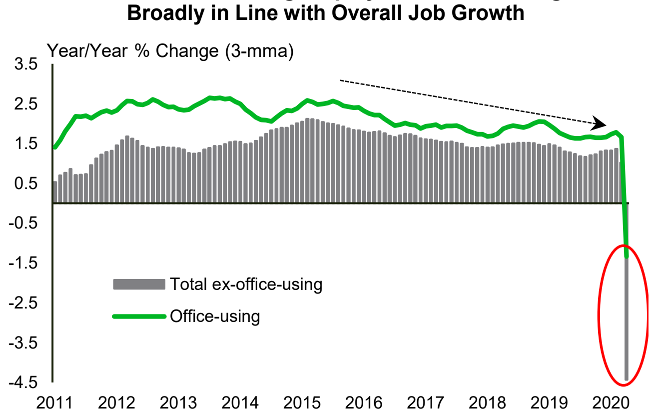
worker preferences to change, shifting away from dense office markets to working from home or flex workspace closer to suburban areas, also poses some risk for traditional office hubs.

That being said, there does seem to be some counterbalancing forces at play. For instance, despite the strong lure of teleworking, many positions could continue to favor the office setup. This is particularly true for jobs that are very sensitive to privacy and security issues (i.e. select banking jobs and IT), those that require frequent face-to-face client interaction (i.e. select banking and real estate jobs) or those that require the use of expensive equipment (i.e. media studios). In addition, those subsegments of the office market unable to have employees telecommute will likely have to adjust office configurations to meet new health standards. This includes more distance between individual work stations, increased containment across departments and/or divisions, and perhaps even increasing the amount of common areas to minimize the number of employee contact points. Co-working spaces, while highly susceptible to the pandemic's near-term pressure, could benefit from the changing landscape once the eye of the storm has passed. Co-working spaces offer flexible short-term leases that range in size, catering to both small and large business needs. Such configurations could prove beneficial when long-term planning becomes difficult and companies are looking to free-up cash for capital expenditure purposes.

The Here And Now

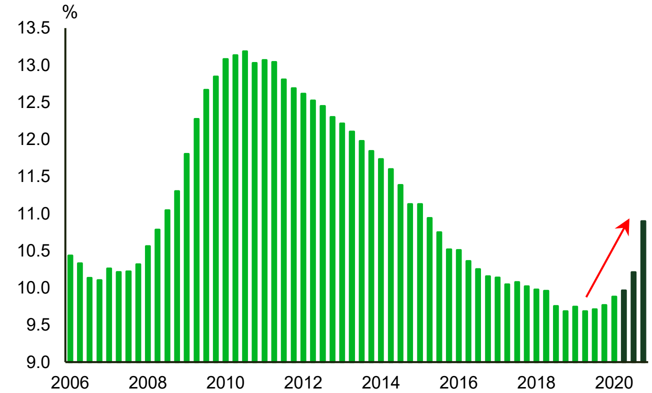
We can't talk about the future without giving an important nod to the present. Like much of everything these days, the near-term narrative for the office sector is no exception in looking quite dim.

Chart 2: Office-using Employment Was Slowing Broadly in Line with Overall Job Growth



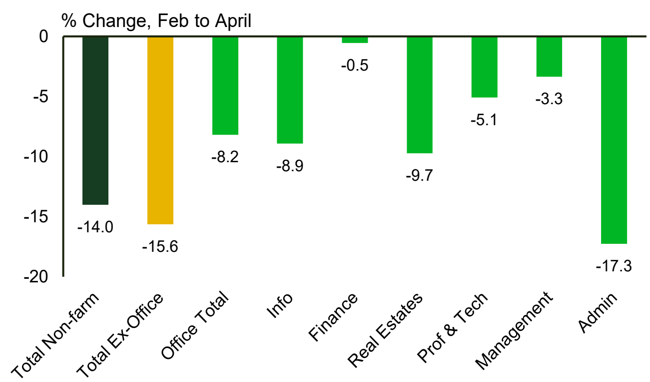
Source: BLS, TD Economics. Last Observation: May 31, 2020

Chart 3: Office Vacancy Rate Set to Rise Sharply



Source: CoStar, TD Economics. Note 2020Q2-Q4 data is an estimate

Chart 4: Office Employment Has Declined by Roughly Half of Ex. Office since February



Source: BLS, TD Economics

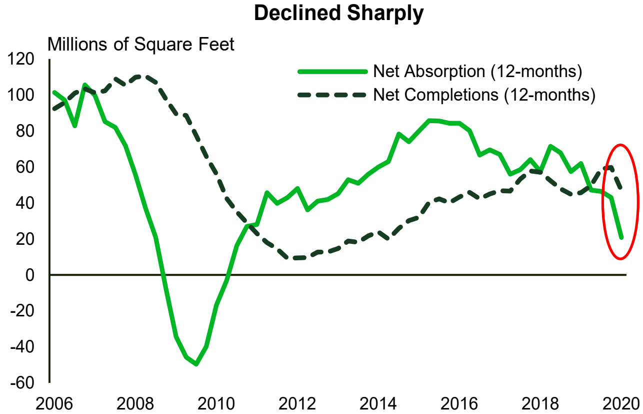
Even prior to the pandemic, demand for office space was on a gradual decelerating path. This was in line with a rising trend in working remotely and a decelerating trend in office-using employment growth (Chart 2). While payroll growth among several categories that make up office employment performed decently on a trend basis – growth in professional and tech services was running at 3% year-on-year at the start of this year compared to 2% in late 2017 – the longer-term slowdown is largely attributable to softer performance in the management of companies and enterprises, as well as administrative services. Despite a slowing demand backdrop, on the other side of the ledger, builders had taken a more conservative approach to new projects in the years that followed the Great Recession. And, with supply continuing to come in near demand, the office vacancy rate had generally continued to narrow, until recently (Chart 3).

However, now the market must contend with a sharp drop in demand in light of the COVID-19 wrecking ball. Evidence from the March through May payrolls suggests that while office-using employment is not bearing the initial brunt of the COVID-19 disruption, it certainly isn't escaping unscathed. Office-using payrolls still fell by 8% between February and May – slightly less than half the decline across all other categories combined (Chart 4). Given that office employees who typically use a computer for work, may be more adept at working remotely, this result is not entirely surprising in the current environment where remote working solutions are encouraged. Having an edge at working from home comes in handy in other ways too. For instance, office-based firms may continue to operate and generate revenue, making it easier to meet existing rent obligations relative to firms that must have their employees working out of a business site but are unable do so at the moment.

Despite a number of elements that may help support the office sector in the short-term, there are still plenty of pain points and risks. For starters, in light of physical distancing efforts and increased uncertainty, new leasing activity is likely to come to a screeching halt over the near-term. The nimbler co-working space segment, which tends to offer shorter-term leases in densely-populated markets, may be at an increased risk as far as renewals or new leasing activity goes. The changing economic backdrop has forced WeWork, a large coworking space provider, to lay off workers and to skip rent payments on many of its locations. Simmering pressures on the coworking space could intensify the woes for the entire office market through increased vacancies and lower rents. This added pressure however, will vary by region. Some markets, for example New York City, are more exposed to co-working space than others – see Text Box 1.

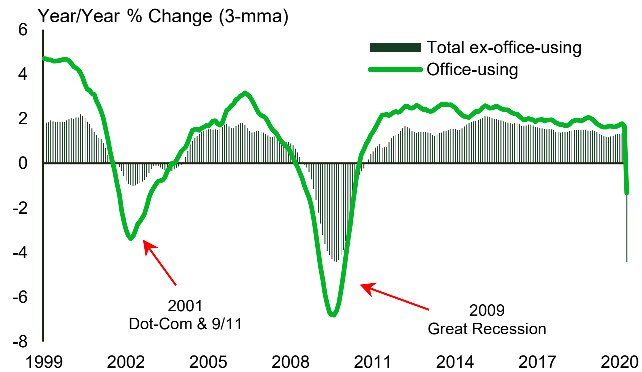
All told, as demand plunges in the near-term, the absorption of new space will undershoot supply, causing vacancies to

Chart 5: Demand for Office Space Has Already Declined Sharply



Source: Costar, TD Economics

Chart 6: Office-using Payrolls Have Seen a Larger Decline over Last Two Recessions



Source: BLS, TD Economics. Last Observation: May 31, 2020

surge (Chart 5). As this happens, negative pressure on rents and prices will follow. The outlook for a recovery later this year hinges closely on the virus' path. The longer the health crisis drags on, the higher the economic toll will be for the office sector. For starters, a prolonged crisis will impede efforts for a quick return of workers to the office. Some firms are already planning for the possibility of a second wave this Fall and have announced that employees will continue working remotely for the remainder of the calendar year. A prorogued health crisis would also point to a more adverse scenario for overall economic growth. Given the extensive links of the office sector to other parts of the economy, demand for office workers, and thus office space, would be impacted too. As an example, advertising-related businesses are at risk of a sharp drop in revenue this year as major national brands curtail their ad spending. Under a more "L" shaped recovery, smaller, less-capitalized firms will be at greater risk in meeting rent obligations. While the current recession may not be viewed as a recession in the traditional sense, the longer it drags on, the more likely it will become one. Under such a scenario, office employment tends to underperform the broader job market (Chart 6).

Pandemic Accelerates Teleworking Trend

As previously mentioned, perhaps the biggest culprit to weigh on future office demand is the ability for employees to work from home or remotely. This is by no means a phenomenon that started as a result of COVID-19. Data from the U.S. Census Bureau suggests that the share of employees that occasionally work from home has steadily increased over the last two decades, rising from 3.3% in 2000 to 5.4% in 2018 (Chart 10). A similar trend has also emerged for full-time employees who primarily work from home, though measured as a relative share of the workforce is a bit smaller.

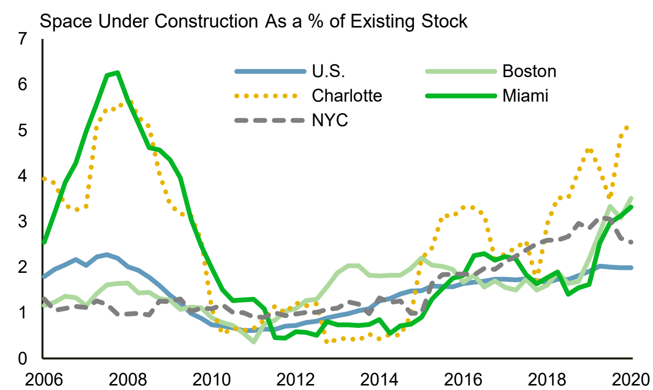
Text Box 1: Heightened Near-Term Risk For Several East Coast Metros

The negative shock from COVID-19 will not be distributed evenly throughout U.S. office markets. As demand for office space takes a major hit in the near-term and falls across the board, those markets that have very rich supply pipelines are likely to be at an increased risk. While some projects may be cancelled or may take longer to come to market as a result of COVID-19 disruptions, the amount of space under construction relative to existing inventory can still be viewed as an important risk indicator.

In this section, we focus on a handful of large East Coast metro areas. The markets with the most elevated supply pipelines as the pandemic hit were Charlotte, Boston, Miami and to a lesser extent New York (Chart 7). The latter marks somewhat of an outlier given that unlike the other metros, its supply pipeline had generally eased in the quarters leading up to the pandemic. The supply-side risk rankings are virtually unchanged when comparing the current supply pipelines to each market's historical trends, with Charlotte still showing the most elevated risks, all else being equal. (Chart 8).

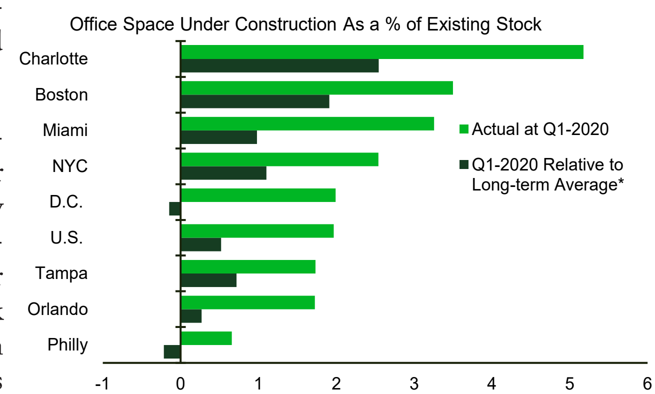
All other things however, are not equal, with the pandemic-induced demand shock also likely to vary widely by metro. For instance, while Charlotte may have the most elevated supply risks, much of the space appears to be already pre-leased, making it less vulnerable to the downturn. The same is not true for many of the other metros. The severity of the demand shock will also vary on factors such as: the spread of the virus, duration of health crisis and the measures taken to contain it. On this front, we are likely to see a north-south divide, with the region's northern metros, likely to see a stronger demand shock given a slower approach to reopening sections of their economies. This is particularly true for the New York metro, who was without question one of the hardest hit areas across the United States. Idiosyncratic factors will also play a role. For instance, on top of likely experiencing the slowest reopening in the region, New York is also highly exposed to co-working space – a section of the office market that is arguably even more susceptible to the current near-term pressures (Chart 9). Developments at a co-working firm WeWork, which has run into difficulty recently, bear careful watching given that the company is the largest private office tenant in NYC. In fact, missed rent payments by office tenants alongside strict social distancing measures and travel bans, which have disproportionally hit retailers and hotel revenues, has already led a sharp increase in CRE delinquency rates, with the 30-day measure tripling in recent months.

Chart 7: Construction Pipeline



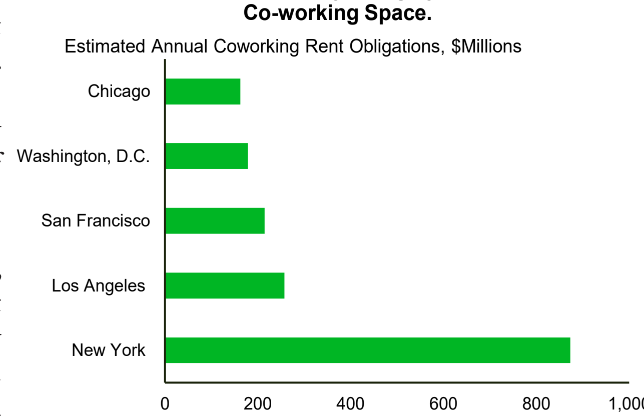
Source: CoStar, TD Economics

Chart 8: Construction Pipeline Elevated in Charlotte and Boston



Source: CoStar, TD Economics. *Average of 2006-2019.

Chart 9: New York City Is Highly Exposed to Co-working Space.

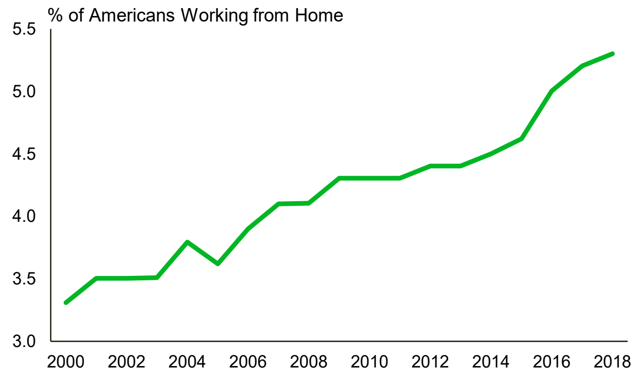


Source: Savills, TD Economics

Unsurprisingly, a significant number of the individuals included in the work from home statistics hold an "office job", working in either information, financial activities or professional & business services. Data collected by the Census Bureau found that in the survey year of 2017/18, slightly less than half of those working in each of the above sectors had the ability to telework on either a part-time or full-time basis – proportions that are significantly higher than most other sectors. The remaining individuals surveyed in each of the big three telework sectors, commuted to an office setting, citing that they were "unable to work from home". This could be because of job responsibilities that require an office presence or perhaps lack of technology to appropriately perform their job from home. However, this has all changed in the wake of COVID-19, which forced nearly a third of the U.S. workforce to work remotely by mid-April.[1] Perhaps more representative statistics for the information, financial activities and professional & business services sectors came from a recent MIT survey conducted in mid-April. It found that of the companies surveyed, more than two-thirds responded by saying that over 80% of their workforce is currently working remotely, while another 15% reported that 61-80% of their workforce are currently working from home (Chart 11). While these figures almost certainly exaggerate the percentage of the office workforce who will eventually telework on a regular basis, it does serve as a proof of concept that many more jobs than previously thought can be done from home.

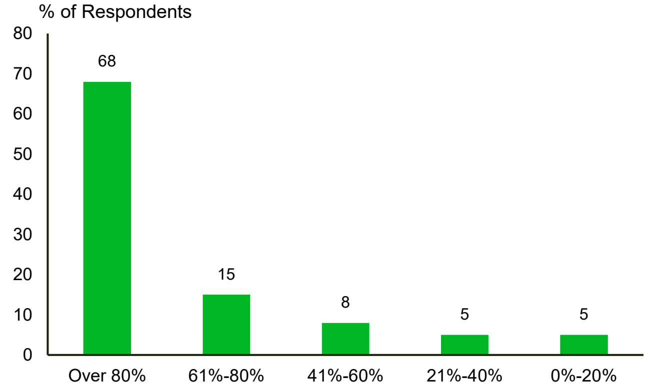
Also supporting the narrative of a higher proportion of employees teleworking moving forward: sunk costs. Since the stay-at-home orders began in April, corporations have deployed significant capital to ensure employees have the technological capabilities to adequately perform job roles remotely. With investment dollars already spent, it seems

Chart 10: Increasing Share of Americans Are Working from Home



Source: US Census, TD Economics

Chart 11: Proportion of Office Workforce Working Remotely in April



Source: MIT Technology Review Insights Survey, TD Economics

unlikely that some of these jobs will return to an office setting, even after social distancing measures are lifted. This is especially true in a post-recession environment, where companies will already be looking to reduce overhead, trimming real-estate costs could be low hanging fruit for some businesses. In fact, several corporations including Google, Twitter and Shopify have already announced that some (or most) jobs will be moving to a permanent work from home model, while countless other companies (outside of the tech world) have also hinted to revamped work arrangements moving forward.

This begs the question, just how big of a shift could we see in the number of people working from home in the years ahead? Based on the MIT Survey, the weighted average among corporations surveyed was that 71% of the "office" workforce is currently working remotely. For illustration, if one assumes that this ratio holds post-pandemic, it would suggest that of just the information, finance and business & professional services jobs, as many as 8 million additional people would work from home (in some capacity) going forward. Of course, using the survey results which are based on current work arrangements in the middle of a pandemic is by no means an accurate depiction of what we're likely to see post COVID-19. But even if one assumes half of those jobs continue to function from home, it still equates to a 25% reduction (or 4 million decline) in the current number of employees working in an office setting.

It's important to keep in mind that of the assumed 4 million workers, not all would exclusively work from home. Some offices may instead move to flex work settings where employees may only telework half the time. Such work arrangements seem appealing over the near-term, as tenants remain locked into existing lease terms and reducing office density will be a top priority for employers as stay-at-home orders are further relaxed. Historical data collected by the CBRE suggests that lease terms for office space can range anywhere from 4-10 years, depending on size – higher lease terms are typically associated with larger spaces. As existing lease terms expire over the coming years, it seems likely that more of these workers will be phased into a permanent work from home arrangements, leading to downward pressure on overall office demand.

Offsetting Forces

For all the pressures implied by technological innovation and the expected shift to remote work, there are a number of offsetting forces that will help slow the pace of decline in office demand in the years ahead. At the core of the "working from home versus office" argument is employee productivity. Many studies, including an often-cited Stanford University study, have shown that working from home may lead to a notable boost to productivity.[2] That being said, not all the evidence is in favor of remote work. For starters, some workers may not have the possibility to set up a productive home office. This is especially true for those that live in relatively small apartments and lack ample private space. In addition, the benefits to productivity tend to vary based on the type of work being done. For example, working remotely may prove beneficial to creative work, but detrimental to work that focuses on dull tasks.[3] The office environment, which is likely to present fewer distractions, may be better for the latter from a productivity standpoint. What's more, unpleasant remote working experiences for some workers during the pandemic (given the abrupt and forced change, and suboptimal working conditions for some), may tilt and reinforce the attitudes of some workers against teleworking. Resistance to change, both from a manager's and worker's perspective, coupled with long-term existing leases or improved leasing terms post-pandemic will also help the work office keep some of its luster.

Looking beyond the productivity argument, there are plenty of other reasons to believe that a large part of firms and workers will continue to favor the office, either on a permanent or a primary basis. This is particularly true for roles that are very sensitive to privacy and security issues. For example, positions that deal with very sensitive customer data (i.e. select banking positions and IT security etc.), where switching to remote work may increase a firm's exposure to cyber breaches. Reducing these risks to an acceptable level will come with additional costs. This may be in the form of higher spending on cyber monitoring and protection or requiring employees to have a dedicated office space at home (i.e. separate room). While equipment costs associated with remote workers may be negligible or looked at as part of doing business, for firms

Text Box 2: Increase In Remote Work Presents An Opportunity For Suburban Flex Space

Densely-populated urban areas like New York City are bearing the brunt of the COVID-19 outbreak. As the pandemic drags on, anecdotal evidence of Americans considering or making the move to less densely-populated areas continues to emerge. According to a recent survey, about two thirds of those working from home due to COVID-19 would consider moving if given that flexibility.[4] Together with a slowdown in immigration, this is likely to accentuate a trend that had developed well before the pandemic, with U.S. population growth increasingly tilting toward suburbs over the last few years.[5] Relatively cheaper and more spacious housing in the suburbs, and the ability to avoid exuberant commutes through a surge in remote work are likely to further aid this trend.

As described in the section above, however, the home office may not be favored by some workers and firms given privacy and security issues, the inability to have direct client-facing or sales interactions, or simply may not be in tune with the employee's preference to have a clear separation between work and home. These shortcomings of the home office may be a great opportunity for suburban flex office space. Whether arranged privately by the employee or through assistance from the employer, suburban flex workspace, which tends to be cheaper than office space in prime urban locations, can address many of the limitations of the home office, while still keeping the core benefits of working remotely (i.e. avoiding long commutes, access to cheaper housing etc.). Ultimately, these alternative arrangements could help soften the blow for overall office demand.

with a high turnover rate this may be a challenge. Traditional office space and the equipment that comes with it can be easily transferred from an employee that is leaving to a new hire. But, a large part of the equipment costs associated with a new remote worker are likely to be largely irrecuperable. More importantly, for firms whose workers utilize or share highly specialized and expensive equipment (i.e. media studios), it may not be possible to transform each worker's remote office into a specialized work office, both from a financial and practical standpoint.

Another category of workers that are likely to continue favoring the office are those in traditional client-facing positions or sales. While improvements in communication technology will undoubtedly take some of the lure out of direct interactions, once the pandemic is over many of these workers – such as those in legal services, select banking positions, real estate sales and leasing etc. – are likely to return to their old ways, with face-to-face interaction likely to remain a crucial part of customer experience and sales generation.

Additional obstacles could emerge against the massive shift to remote work. Facebook recently suggested that it would 'adjust' pay depending on location for remote workers. For those moving out of expensive Silicon Valley, this is likely to mean a reduction in pay. While an employee could still be better off working remotely from another location, for example due to significantly improved housing affordability, it does pose other challenges, such as potentially limiting career advancement opportunities with little to no office presence.

Lastly, changes in office layout may also provide a small tailwind to office demand in the post-pandemic world. While firms will have a reduced appetite for office space as more workers shift to teleworking, those that continue to favor the office setting are likely to seek out more space per employee in order to meet new health recommendations. This would mark a turning point from the trend observed over the last several years, when the size of cubicles had continued to shrink. Apart from heightened virus-preventing efforts (i.e. abundant use of sanitizers; adoption of more touchless technology etc.), the office of tomorrow is likely to feature more elbow room between desks, increased containment between teams and potentially more common areas to reduce employee contact points. This trend is likely to be aided by a leaser's improved bargaining power during and after the pandemic. Suburban markets, where rents are cheaper, could also see a bit of an upside (see Text Box 2).

Bottom Line

The COVID-19 pandemic will be a key element in reshaping the future of the U.S. office sector. Looking beyond the near-term pressures, such as rising vacancies as demand for office space temporarily grinds to a halt, the pandemic is also poised to have longer-lasting impacts. One of the pandemic's key legacies is likely to be an increased intensity in teleworking. This is particularly true across information, financial activities, and professional & business services jobs, which had already been experiencing a steady increase in the propensity to telework over the last decade. The health crisis will help to accelerate this trend over the coming years, leading to slower overall demand for traditional office space.

Outside of slowing demand, we are also likely to see some shifting in preference for both the type and location of office space demanded. Traditional urban office hubs could become less desirable, as companies look to downsize their real-estate footprint in favor of a more fragmented office setup located across various suburbs. This would help address immediate concerns of reducing office density, while also lowering real-estate costs – a key focus for all businesses as they emerge from the recession.

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