Trouble in the Office Market:
"Deja Vu All Over Again"
May 26, 2023

The media has been reporting rising office vacancy rates in many major cities. Concerns have been expressed about declining commercial property values and potential reductions in city tax revenues. Channeling Yogi Berra, I was reminded of the New England "credit crunch" in the late 1980s and early 1990s and particularly of how sharply the values of office buildings can fall when supply exceeds demand.

During the 1980s, the nation experienced a boom in office construction. New England was on the forefront, having had very little office construction in earlier decades and now enjoying growth in industries that occupy office space. Unfortunately, the supply of space overshot demand, creating problems for developers, landlords, and the banks that financed them. Some banks failed. All banks tightened lending standards. And many borrowers had difficulty finding credit – hence the term "credit crunch." In large part because of problems in real estate and banking, the 1990-91 recession was much more severe in New England than the nation.

The Federal Reserve Bank of Boston was active in trying to understand and address the banks' problems and cutbacks in lending. In 1992, the Boston Fed held a conference, *Real Estate and the Credit Crunch,* focused on these issues. While housing played a role, office buildings were the real nemesis of the banks. I co-authored a paper with the late Chip Case on this topic[1] and I was struck at the time by how low commercial property values can go. All the inputs into property valuations can turn sour at once.

Office Cycles

Real estate markets tend to be cyclical. Construction and real estate transactions are highly sensitive to interest rates; so when the central bank raises or lowers interest rates, the real estate sector reacts. However, the office market seems especially susceptible to overshooting. The time required to plan, permit, and build an office building is long. Construction itself commonly takes two years or more, but planning and permitting may take much, much longer. Thus, if demand for office space increases, supply does not immediately respond. The delay causes rents to rise above the level that will prevail in the longer term when the increase in supply comes online. If developers and lenders do not recognize the short-term nature of the rent spike, they may be tempted to expand supply even more, requiring a still larger downward adjustment in rents.

If demand falls short of supply, the adjustment can be painful and prolonged. Office buildings last a very long time. When demand drops off, the supply of space decreases slowly if at all. Thus, the burden of adjustment falls on rents. Newly completed buildings,

[1] Browne, Lynn E. and Karl E. Case. 1992. "How the Commercial Real Estate Boom Undid the Banks." In *Real Estate and the Credit Crunch,* edited by Lynn E. Browne and Eric S. Rosengren. Proceedings of a Conference sponsored by the Federal Reserve Bank of Boston. Conference Series No.36.

unless owner-occupied or irrevocably pre-leased, cut rents below projected levels to attract scarce tenants. Rent reductions may take the form of rent-free periods and extensive customization of space to tenants' needs as well as cuts in the stated rental rate. For a time, existing fully leased buildings may seem shielded from the downturn because of multi-year contracts. But as leases expire, tenants shed space even as they demand lower rents. Frequently, tenants vacate older buildings for newer properties with more amenities, as well as reduced rents. In the interim, tenants will try to negotiate lower rents and may sublease space to other companies. Subleasing tends to bring in smaller and less financially stable tenants.

Today and 1990

The New England credit crunch was largely due to a surge in office construction, which was a response to limited construction in prior decades and to improving economic prospects in the region. Unfortunately, much of the new space arrived as defense cutbacks and competitive challenges to regional computer manufacturers interrupted New England's economic advance. These setbacks proved temporary, but at the time the outlook was gloomy. Office vacancy rates rose, rents fell sharply, and the values of office buildings plummeted. New England's commercial banks, which had lent aggressively to the region's construction and real estate industries, suffered losses and almost 30 (14 percent) failed. Credit became harder to get and loans came with more strings.

Today, the primary cause of problems in the office market is changes in work arrangements caused by the pandemic. However, construction of office buildings nationally was relatively strong going into the pandemic, so that new space became available in many markets just as office workers shifted to working from their homes and other remote locations. Working from home seems to be more feasible for industries that occupy office buildings than other industries; and while employers are now encouraging employees to return to the office, workers are resisting. It seems plausible that work patterns have undergone a long-term change and that the need for office space will be less in the future than expected pre-pandemic.

Office vacancy rates rose in most markets between the first quarter of 2020 and the first quarter of 2023. However, vacancy rates rose more in some places than others. In some markets, supply increased at just the wrong time. In some cases, employee reluctance to return to the office has been reinforced by perceptions that crime increased and city services deteriorated during the pandemic. Some markets have experienced out-migration of both people and jobs. Finally, while the U.S. labor market was still tight when this was written, announcements of layoffs at prominent technology companies and several high visibility bank failures have raised doubts about the strength of future demand from important office-occupying industries.

When It Rains It Pours

New England's experience in the credit crunch highlights how dramatically property values can sink in a market where demand for office space falls short of supply.

Low demand reduces the rents office buildings can command, if not immediately then as leases come up for renewal. Low demand also means higher vacancies and lower occupancy rates. As noted above, vacancies migrate over time, from newly completed buildings to established buildings with fewer amenities. Lower rents interact with lower occupancy rates to reduce the gross rental stream generated by the building. Since property taxes and operating costs are unlikely to fall in concert, the percentage decline in net operating income will be larger than that in gross rent. The squeeze on net operating income will be larger to the degree operating costs are large and relatively fixed.

The coup de grace is the "cap rate" investors use to evaluate the income stream from a commercial rental property. The cap (or capitalization) rate is the ratio of net operating income to the property's value. Cap rates enable investors to compare potential returns across properties and across markets. Riskier investments require higher returns. Risk factors include building age, maintenance needs, location within the market, tenant quality and lease terms. Higher quality (class A) office buildings generally have lower cap rates than older, lower quality buildings; so for the same net operating income a Class A building has a higher value than a Class B or Class C.

Cap rates also move positively with interest rates. Higher interest rates raise the cost of financing investments in real estate and offer alternative investment possibilities. Accordingly, increasing interest rates will tend to raise cap rates and reduce property values across the board.

The following illustration highlights potential interactions.[2] Start with a Class A building with gross rental income of $3.5 million and 100 percent occupancy pre-pandemic. Net operating income is $2.5 million. The market value is $50 million with a cap rate of 5 percent. Post-pandemic, some tenants have moved to newer buildings, while others have reduced their space needs and demanded concessions on rent. Gross rental income falls 20 percent to $2.8 million. Operating costs are unchanged; so net operating income declines to $1.8 million – a decrease of 28 percent. With a 5 percent cap rate, the building would be valued at $36 million. However, interest rates have risen and the future demand for office space is uncertain; cap rates for Class A buildings have increased to 7 percent, reducing the building's value to $26 million. On top of this, the neighborhood in which this building is located has seen an increase in crime and many shops and restaurants have closed. There is a risk that the building could lose its Class A status and see its value fall to $20 million (cap rate of 9 percent.)

In sum, the office market has been hit by a multiplicity of unfavorable developments: higher interest rates, falling rents and occupancy rates, increased uncertainties about future demand, and in some locations perceptions of increased crime and public disorder. All of these undermine property values through reduced income, higher cap rates or both.

[2] This example is based on one that in the Browne and Case 1992 paper but cap rates are lower and more reflective of recent experience..

What to do?

The best answer to rising vacancies and declining values in office markets is growth in industries that either use office space or require the services of office-using industries. That is what happened in New England, especially Massachusetts, after the credit crunch. Growth in information technology industries was spurred by the dot.com boom and by Y2K preparations. Life sciences research emerged as an important user of lab space.

The change for the better was not readily apparent until the second half of the 1990s and lessons from New England for stimulating growth today are not obvious. However, a few have argued that early recognition of the decline in office values in New England was actually a healthy development and contributed to the regional recovery. While the decline in values hurt the original owners and lenders, those who bought properties at distress prices could offer substantially lower rents. Tenants benefited from lower costs. Buildings were occupied and maintained. They did not stay empty, looming over the market and threatening to compete for tenants when demand for space picked up.

Markets where population and jobs are growing will have an easier time adjusting to reductions in space needs from new work arrangements than markets where population and jobs are declining. Jobs can be generated locally or drawn from elsewhere. At the state and regional level, cities compete for tenants with suburbs and large cities compete with smaller. At the national level, large markets compete with one another for tenants that employ lots of workers themselves or have the visibility and prestige to attract others.

This competition is not new; but the speed and ease with which work arrangements shifted in the pandemic demonstrated that both companies and employees have more flexibility and more choices than previously realized. This suggests that the quality of the office work experience, broadly defined to include commuting and opportunities for post-work socializing, as well as building amenities, has become more important to competing successfully for tenants.

For landlords, a critical challenge is how to cut costs in response to reduced rental incomes without cutting maintenance necessary to preserve building quality. With lower property values borrowing is more difficult. Buildings last a long time, but if not well maintained they will have to settle for a less desirable tenant mix and may effectively drop from supply through quality declines and physical deterioration. At the same time, the presence of poorly maintained and low occupancy buildings makes attracting desirable tenants more difficult for healthier buildings in the vicinity. Falling property values should lead to lower property taxes. This will help landlords in the short term, but widespread tax reductions could lead to counter-productive cuts in public services over time.

There has been much talk about reducing the supply of office space by repurposing office buildings into housing. While a few successful examples exist, in my admittedly non-expert opinion, this is not a promising strategy. It may be feasible in some densely populated inner suburbs and small cities, where residents and office workers already intermingle and where retail, entertainment and service establishments already meet the needs of both.

However, most discussions about repurposing offices into housing seem focused on downtown locations in large cities.

The configuration of modern office buildings is not well suited for housing. Floor areas are too large, with too much interior space relative to windows. Windows do not open, and HVAC systems are designed for large open areas. Office buildings are often located in areas that lack supermarkets and recreational spaces suitable for families. Because repurposing office buildings into housing units will be expensive, private developers and investors will undertake such projects only if they expect to sell or rent the units at high prices. That means luxury housing, and most advocates of repurposing want the opposite. Whether the presence of large non-luxury housing complexes increases the financial viability of neighboring office buildings does not get much attention. Nor has there been much discussion of whether the demand for housing will remain strong if office work in the market is not increasing.

Conclusion

Changes in working arrangements caused by the pandemic have probably caused a long-term decline in the demand for office space and a substantial decline in the value of office buildings. Markets where underlying growth in population and jobs is strong will adjust more readily than areas markets where jobs are declining. The latter face the risk of negative feedback, with dwindling rental income leading to reduced maintenance which reduces office quality and raises cap rates, reducing values even more. Public officials must take care that perceptions of higher crime rates and public disorder do not contribute to the downward pressure.