

OFFICE INDEX

MORE QUESTIONS THAN ANSWERS IN THE OFFICE SECTOR

The total return for the office segment of the NPI was 0.31% in Q3 2020. The income return held firm from the prior quarter at 1.08% and the appreciation component was negative 0.77% with owners taking modest write downs. On the face of it, these returns may feel at odds with the fact that the pandemic has most office properties operating at just 10% to 15% capacity. Probably the best reason that NPI office returns have not fallen off dramatically since the onset of the pandemic is the fact that the index measures the performance of higher quality institutional assets that are generally encumbered by leases to credit tenants with significant remaining term. Also, rent collection at these properties remains in the 93% range. So even if it takes three to four years for office markets to fully recover, in many cases, these assets are relatively well positioned to weather the worst of the storm. While transaction activity remains sparse, there are still some investors willing to pay pre-pandemic pricing for well leased properties with minimal near-term rollover.

As we move through the remainder of the pandemic and into its aftermath, we can expect landlords to become increasingly aggressive in their quest to maintain occupancy and lease up vacant space. Depressed demand in the foreseeable future will certainly result in longer downtime for vacant space. So far, most landlords are offering increased concessions such as free rent and tenant improvements, but in some cases asking rents are also beginning to drop. There is a strong probability that flagging fundamentals, coupled with a dwindling duration of the average remaining lease term, will put downward pressure on office property values as we head towards the end of 2020 and into 2021.

The greatest wildcard for the performance of the office sector moving forward will be the lasting impacts of the pandemic. These impacts will not only be important determinants of the recovery, but they have the potential to cause permanent structural shifts in office demand. For now, the consensus is that work-from-home and flex office options will become significantly more prevalent and accepted post-pandemic. Tech firms like Facebook, Microsoft, and Dropbox have been leading the way in these initiatives by providing their employees with greater autonomy in their decisions to come to the office. These trends, if they persist, suggest a smaller future office footprint for most companies. On the positive side of the ledger, however, is the possibility that increasingly health conscious office workers will require more space as they continue to maintain some degree of social distance into the future. Finally, while the work-from-home phenomenon has shown us all the things we can accomplish without coming into the office, it has also made us appreciate the value of our office interactions and in-person relationship building, which are crucial ingredients of innovation and productivity.

There are many competing influences and crosscurrents that make the outlook for the office sector uncertain. Further complicating matters in the near term is the uneven and wildly varying impact of these influences across different assets depending on their locations, physical attributes, and income characteristics.

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OFFICE TOTAL RETURNS

	Total NPI	Total Office	East	Midwest	South	West
3rd Q 2020	0.74	0.31	0.23	0.49	0.27	0.38
2nd Q 2020	-0.99	-0.50	-0.55	-1.23	-0.96	-0.17
One Year	2.00	2.81	1.69	0.78	2.45	4.52
Three Years	5.11	5.38	3.66	3.57	6.07	7.48
Five Years	6.28	5.87	4.31	4.54	5.80	7.98
Ten Years	9.37	8.74	7.59	6.29	8.52	10.70
Twenty Years	8.30	7.56	7.82	5.32	6.91	8.24

OFFICE INCOME RETURNS

	Total NPI	Total Office	East	Midwest	South	West
3rd Q 2020	1.02	1.08	1.02	0.99	1.25	1.11
2nd Q 2020	1.01	1.08	1.02	1.04	1.23	1.11
One Year	4.30	4.39	4.12	4.29	5.00	4.52
Three Years	4.48	4.49	4.15	4.78	5.27	4.57
Five Years	4.58	4.51	4.15	5.07	5.40	4.54
Ten Years	5.13	5.01	4.70	5.75	5.76	5.00
Twenty Years	6.04	6.05	5.89	6.63	6.57	5.94

OFFICE APPRECIATION RETURNS

	Total NPI	Total Office	East	Midwest	South	West
3rd Q 2020	-0.28	-0.77	-0.79	-0.50	-0.98	-0.73
2nd Q 2020	-2.00	-1.58	-1.57	-2.27	-2.19	-1.28
One Year	-2.22	-1.54	-2.35	-3.40	-2.46	0.00
Three Years	0.61	0.87	-0.47	-1.16	0.77	2.82
Five Years	1.64	1.32	0.16	-0.51	0.38	3.33
Ten Years	4.09	3.61	2.80	0.52	2.65	5.49
Twenty Years	2.17	1.44	1.85	-1.26	0.31	2.20

OFFICE INDEX—QUARTILE RANGE OF RETURNS

ONE-YEAR RETURNS

