U.S. OFFICE SECTOR FAQs

What We Learned Q1 2021

CUSHMAN & WAKEFIELD

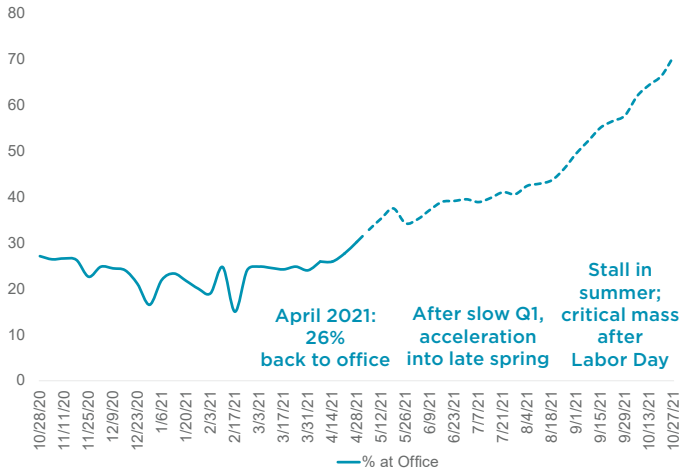
May 7, 2021

Q: With the U.S. making significant progress on the vaccine front, what is Cushman & Wakefield Research's current assumption on when most workers will return to the office?

A: Most are still penciling in September of 2021.

As of April 2021, 26% of U.S. office workers were back at the office. Given the significant progress being made with the vaccination programs—it is assumed that 70% of the U.S. adult population will be vaccinated by July 2021—we expect to see the weekly occupancy numbers gradually improve from here. That said, the return to the office is going to be uneven, some will push to go back sooner (as we are already observing with some banks and tech companies) and others will go back later. One interesting data point to note is that in Australia, where new infections have been at extremely low levels for several months, occupancy levels are now beginning to approach something closer to normalcy. Sydney, for example, is back to 75% of 2019 occupancy levels. In the U.S., most are still coalescing around this idea of returning after Labor Day—recognizing that people will travel this summer and see family and friends and then return to the office in the September timeframe. Clearly there is still a lot of uncertainty around this date but that is the current assumption in our baseline outlook.

Weekly Occupancy Report



Source: Kastle Access Control System Data, Cushman & Wakefield Research Forecast

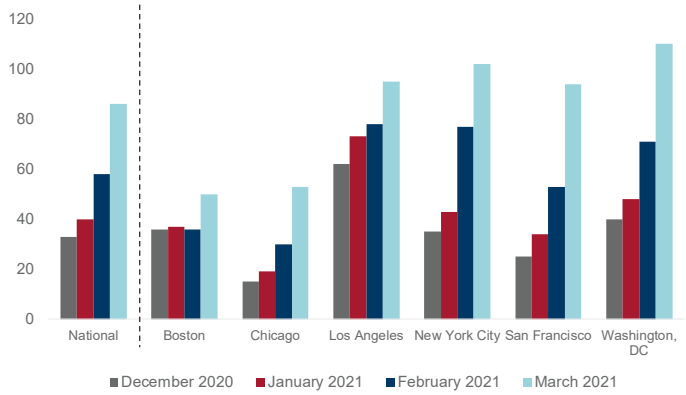
Q: What was tour activity like in Q1 2021? Any signs that it is improving?

A: Yes, in fact tour activity is surging.

Office leasing tours came to an abrupt halt last spring as the pandemic spread across North America and office workers broadly worked remotely. By May, leasing activity was down 85% nationally according to VTS' office demand index (VODI). After some improvement over the summer, Q4 activity was flat.

2021 has been a different story so far. Tour activity started picking up in February, and then in March it surged back to near-pre-pandemic levels. From December 2020 to March 2021, office leasing tours have increased by 161% nationally. Several gateway markets saw doubling of activity over those three months: San Francisco +276%, Chicago +253%, New York City +191% and Washington, DC +175%. Tour activity is typically a leading indicator for accelerated leasing activity. In Washington, DC, for example, the number of lease proposals sent out has been increasing since August 2020, and March 2021 was the second strongest month in the past two years for lease proposals sent. All of this activity bodes well for lease executions over the next several quarters.

VTS Office Demand Index (VODI)



Source: VTS Office Demand Index (VODI), March 2021 Report

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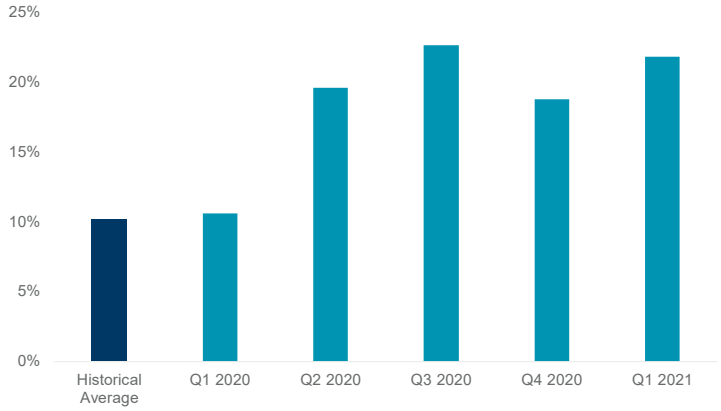
Q: Last year, Cushman & Wakefield Research reported that an unusually high percentage of businesses were signing short-term renewals as a bridge to a better day. Is that continuing into 2021?

A: Yes.

Historically, 10.2% of all U.S. renewals signed are for less than one year. Last year, that jumped up to 22.6% in Q2. Since the pandemic began four quarters ago, one-fourth of all renewals have been for less than one year. The number has ticked down over the past two quarters but remains elevated. Clearly some businesses remain in wait-and-see mode and are simply delaying longer-term real estate decisions until there is more certainty about their business and how much space they will need. That said, this is not the majority. In fact, over 75% of leases signed in Q1 2021 were for more than one year, and nearly 40% were for four years or more.

Short-term Renewals Still Elevated

Percentage < 1 Year Long



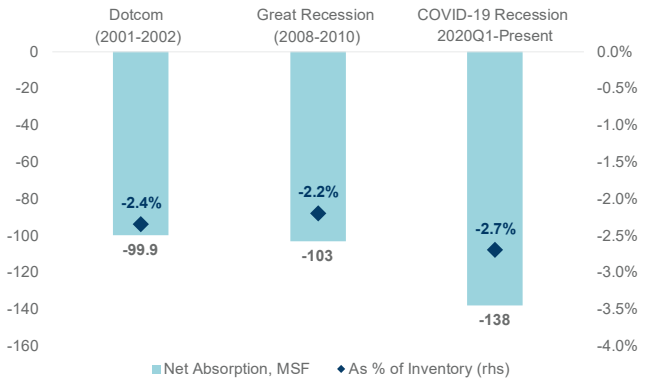
Source: Cushman & Wakefield Research

Q: How much will U.S. office demand decline due to the pandemic and increased work from home (WFH)?

A: Unclear.

When we analyze the employment data, it indicates that the recession itself has played a major role in the negative absorption that we have observed so far. As of April 2021, the U.S. was still down one million office-using jobs from the pre-pandemic peak. Doing back of the envelope math, one million jobs at 150 sf per worker = 150 msf of negative absorption. That lines up with the negative absorption we have observed so far during the pandemic (-138 msf). The good news is that the worst of the recessionary impacts are over (i.e., the U.S. is adding jobs again), and now we will see how the WFH dynamic filters through. Moreover, the WFH impact is likely to be gradual—only occurring as leases expire over the next 10 years. To view our work from home assumptions, see our global office impact study for details.

Already More Severe Than the Great Recession



Source: Cushman & Wakefield Research

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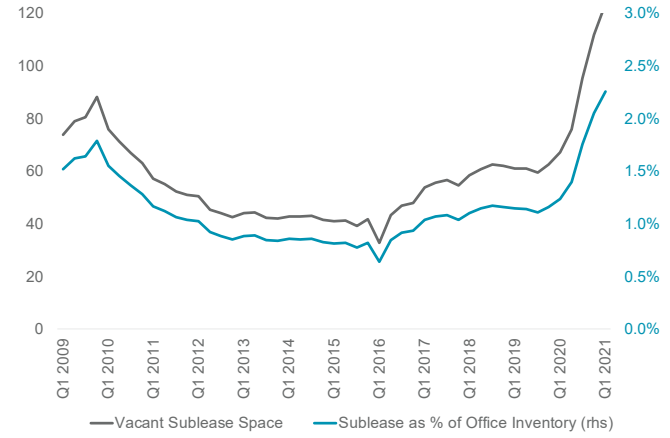
Q: Of the negative absorption that has occurred in this cycle, how much of it was related to sublease space?

A: Over 40%.

Of the 138 msf of negative absorption that has occurred since Q1 2020, 56 msf (41%) of that is due to the increase in vacant sublease space.

Sublease Space Surge



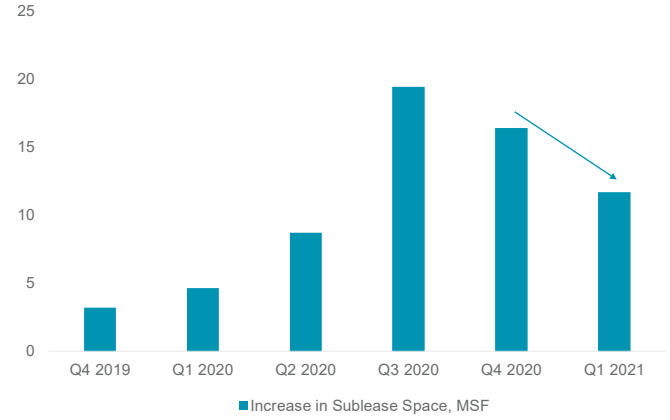
Source: Cushman & Wakefield Research

Q: Is more sublease space expected to be added to the market in 2021?

A: Yes, but at a slower rate.

In the first quarter of 2021, 11.7 msf of vacant sublease space was listed on the market. This is down from 16.4 msf added in the fourth quarter of 2020 and 19.4 msf added in the third quarter. So, sublease space growth is trending lower. We also note that, in this cycle, businesses have been more aggressive in putting sublease space on the market than they were in the GFC. From 2008-10, a total of 33.1 msf of sublease space hit the market, representing 32% of the -99.9 msf of negative absorption recorded in that recession. And it came on over almost two years, or at a rate of about 4.7 msf per quarter, much slower than the 14.1 msf rate we have seen over the last year. Not surprisingly, the peak sublease vacancy rate in the GFC was lower than what we currently observe: it peaked at 1.8% of total inventory at the end of 2009 versus sitting at 2.3% today. Sublease space as a proportion of office inventory remains below its Dotcom peak of 2.9%.

Sublease Space Still Rising but at a Slower Rate



Source: Cushman & Wakefield Research

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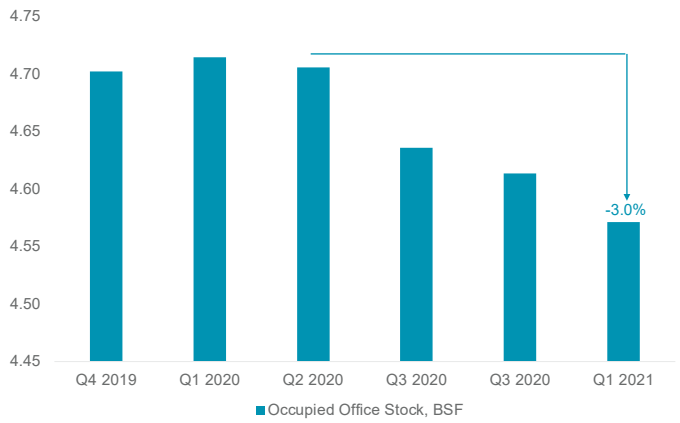
Q: On average, how much have businesses reduced their footprint since the pandemic began?

A: Unclear.

While there's been a lot of speculation about what will happen, what the data is actually telling us is that, in the U.S., the total amount of occupied stock has declined by less than 3%. That's not insignificant; again, it equates to -138 msf of negative absorption, but it's not as dire straits as some make it out to be. So far, this is roughly on par with what we observed during the Great Recession. But there is a lot of nuance going on behind the scenes. Smaller tenants have been more likely to abandon their leases altogether with the plan of signing a new lease after the pandemic subsides. For the smaller tenants that opted to renew, they have tended to renew their lease for the entirety of their current space, while some of the larger tenants have reduced somewhere between 15% and 30%. It is also worth noting that many businesses have not yet made changes to their office footprint, up or down, as the bulk of leases have not yet expired. The reality is that it will be years before anyone has a clean read on the how the pandemic and the WFH dynamic will impact office footprints.

Total Occupied Office Stock



Source: Cushman & Wakefield Research

Q: How could density (i.e., square feet per worker change post-COVID-19?

A: This is complicated.

Pre-pandemic, square feet per worker (workstation + community space) averaged 193 sf and ranged from 150-250 sf. This varied significantly depending upon geography and industry. Post-pandemic, the square feet per worker metric will likely become less important given the widespread adoption of flexible workplace strategies (i.e., rotating shifts, hoteling, remote work).

Post-pandemic, many companies will be reconfiguring the balance of office, with a decreased emphasis on individual workstations and an increased priority for flexible communal space. In many cases, the square footage per employee will remain the same or shrink slightly as an increasingly agile workforce takes advantage of multiple work locations in a given week (e.g., core office, home office, third place, etc.). The square footage per desk, however, will likely increase as more space is dedicated to collaboration, community, huddle rooms, and employee amenities. As previously stated, it's complicated.

Q: Are most businesses adopting a hybrid model?

A: Not yet.

It's important to point out that a good portion of the office world was already "hybrid" well before COVID-19. Businesses allowing remote work isn't a new concept. Other than allowing more people to work from home more frequently, for many businesses, the post-pandemic office model may not look entirely different than it did before.

That said, this event is causing more businesses to explore the hybrid model (i.e., a mix of office, remote work and sometimes coworking or other third places); however, businesses are also learning that it is easier said than done. Part of the reason for the slow adoption is that it is proving to be difficult to implement—particularly in the middle of a pandemic. Just consider the types of questions that a business must consider when reconfiguring space to go hybrid: What if employees all want to come into the office Tuesday to Thursday—will there be space to accommodate? What if some employees prefer to work in the suburbs closer to their home, but most still want to be downtown? What if some top talent prefers to keep a big corner office when they return? Who will train and mentor younger employees if managers are working remotely? What program will be used to reserve desks, and how long will it take to get staff trained to use that program?

But certainly, flexibility is king, and employers are going to look to build in more of remote capability.

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Q: When will effective office rents rise again?

A: Second half of 2022 / 2023.

In the first quarter of 2021, we estimate that effective rents—which factor in concessions—were down 12% in the major markets versus a year ago and down 5% in the non-major markets. Again, the usual "pandemic disclaimers" apply (i.e., much smaller sample size of deals to draw from and an abnormally high percentage of short-term renewals). It is very difficult to get a clean read on rental rates at the moment.

Starting rents (sometimes knowns as "contract rents") are generally holding well but concessions are rising sharply. Average tenant improvement allowances in some major markets have risen from approximately $70 per square foot pre-pandemic to $85-$90 as of Q1 2021. For Class A space, it is not uncommon to see TIs in certain major markets well over $100 a foot along with 6-18 months of free rent.

In general, rents will follow vacancy. As vacancy pivots from rising to falling, rents will follow at a lag. We model that effective rents will begin to stabilize in the second half of 2022 and being rising again in Q1 2023. Of course, real estate is an intensely local product and not every city, every submarket, every building will follow the same glide path.

Q: Are businesses moving from large expensive cities to small cities due to COVID-19?

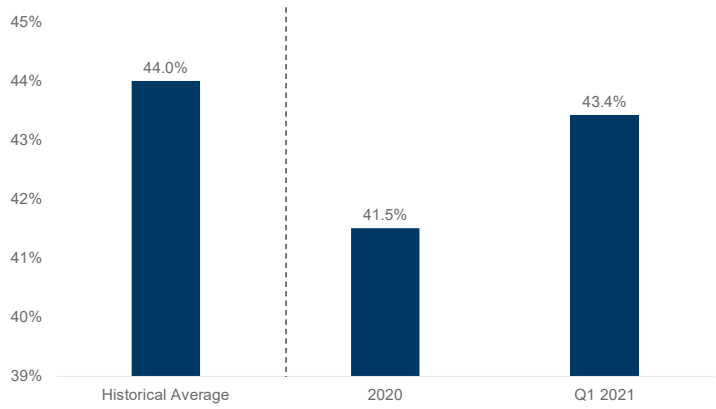
A: Some, but not en masse.

Cushman & Wakefield Research tracks 87 office markets across the U.S., totaling 5.4 billion square feet of inventory. According to our data, historically 44% of all office leases nationwide occur in the six gateway cities: Boston, Chicago, Los Angeles, New York, San Francisco and Washington, DC. In 2020, that percentage dipped to 41.5%. While that could suggest there was some movement out of gateway markets due to the pandemic, it is worth observing those same cities were the ones hit hardest by the pandemic. So, perhaps the drop in leasing activity simply reflects the fact that it was more difficult to do leases in areas where COVID-19 was raging the most. We also note that in the first quarter of 2021, the share of leasing that occurred in the gateway cities slightly ticked up to 43.4%. And as noted earlier, touring activity rebounded in March 2021 to pre-pandemic levels for four of the six gateway markets.

However, that doesn't mean that some businesses aren't going to move. In analyzing housing data and population data, we do know that the pandemic caused people to move to lower cost markets at a rate that was larger than the pre-pandemic norm. But in terms of businesses, there has been far less movement, which also makes sense. Leases are longer and relocating a business is a bigger decision, likely a trailing indicator.

Our view is that the migration trend is a bit overstated and that once the pandemic is over, there will be a strong return to the gateway cities for all the reasons businesses were there in the first place: clustering/innovation, thick labor pools, infrastructure, mass transit, amenities, airports, arts and entertainment, restaurants, etc. Moreover, we note that in some of the global cities we track, where the virus is more contained (e.g., Beijing, Shanghai, Sydney) those cities are already snapping back to life.

Percent of Total Leasing That Occurs in Gateway Cities



Source: Cushman & Wakefield Research

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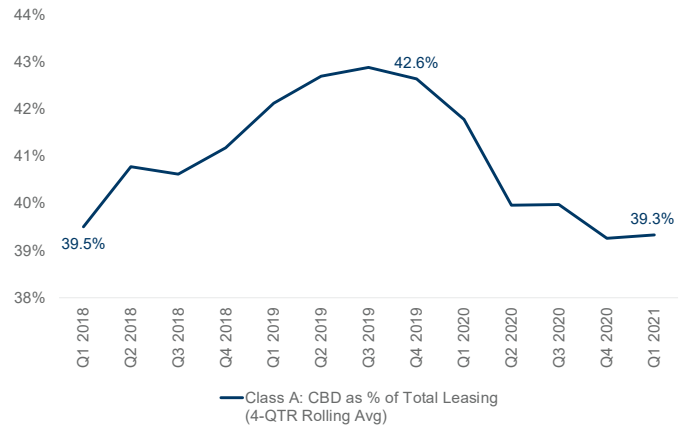
Q: Are businesses leaving CBDs?

A: Some, but again, not en masse.

According to our data, CBD submarkets accounted for 41.2% of Class A office leasing in 2018 and 42.6% in 2019. The four-quarter rolling average dropped to 39.3% during the pandemic, so that does suggest that perhaps there has been some movement out of CBDs. However, similar to our notes on gateway markets, CBDs were more deeply impacted by the pandemic—via health concerns, government restrictions and reduced commuter/consumer activity. This could be part of the reason leasing was lower proportionally since the pandemic started. Moreover, the current ratio remains within historical norms. In Q1 2018, for example, the share of CBD leasing was a very similar 39.5% vs. 39.3% today.

CBD as % of Total Office Leasing



Source: Cushman & Wakefield Research

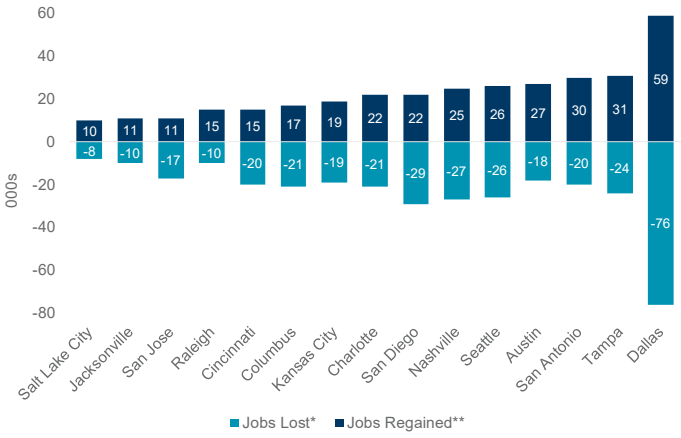
Q: Are any markets performing better than others?

A: Maybe?

It's a little early to identify the best performers since 75 of our 87 markets tracked reported negative absorption in the first quarter. However, if we look at employment data, some of the markets that have recovered jobs fastest are among those that had strong office markets prior to the pandemic. In particular, Austin and Raleigh/Durham have already recovered all of the office-using jobs that were lost in the pandemic and are growing. Then again, the connection between the labor market and demand is a bit off-kilter. For example, Austin's net absorption as a percent of inventory is down nearly as much as San Francisco, and it is in the top five markets with the highest sublease rate.

It is fair to say that Sunbelt markets are seeing better than average real estate market performance so far. That said, in the large gateway markets, like Manhattan and San Francisco, we are starting to observe some early signs that the worst might be over. Although vacancy in those two markets was still rising in Q1 2021, it was doing so at a slower rate and growth in sublease space vacancy is also slowing.

Jobs Lost / Regained During the Pandemic
Top 15 Markets Ranked by Jobs Regained



Source: Moody's Analytics, Cushman & Wakefield Research

*Jobs lost in March and April 2020; **Jobs added in May 2020 through March 2021

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Q: Is office demand expected to vary across different types of tenants (e.g., tech/finance or large corporate/small business)?

A: Yes.

That said, there isn't enough data to draw strong industry correlations. But anecdotally, yes, office demand varies greatly depending on tenant and sector, and we could go one step further and say that demand varies from business to business within the same sector. We are seeing that play out in the tech sector; some are moving forward with an office-centric culture and some are open to going more remote. It is also worth noting that much of the financial stress from this recession has been concentrated in smaller businesses. The big corporates are generally holding up well in this cycle, but smaller businesses are struggling and, because of that, they are more likely to temporarily go fully remote to get through this period rather than pay the real estate costs.

Q: Is the U.S. office sector ever going to fully recover from this event?

A: Yes.

Our thesis on the office sector hasn't changed. The office sector will return to pre-pandemic levels of performance—it's just going to take time. Regardless of how remote working shakes out, the economy is going to continue to produce knowledge-based workers, business formation will improve, and people have to sit somewhere, and most do not want to sit at home all of the time. Data collected in conjunction with CoreNet Global indicates that companies are not any more likely to consider a remote-first workplace portfolio strategy than they were pre-pandemic. Unless for some reason we all decide we don't want to sit under the same roof ever again, it is reasonable to conclude that office buildings will repopulate, it's just a matter of time. In our baseline scenario, U.S. vacancy will reach an inflection point and begin to improve, starting in the second half of 2022 and will generally fall precipitously downwards from there.

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