American Assets Capital Advisers

A SPECIAL REAL ESTATE MARKET COMMENTARY

Don’t Come into the Office Today

SIGNIFICANT HEADWINDS FOR THE OFFICE SECTOR

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THEMES

COVID-19, office sector, lifestyle shifts

READ TIME

15 minutes

Technological advancements have given us the ability to work remotely, but it wasn’t until COVID-19 that society gained a general acceptance of this. We at AACA believe this (and a handful of other structural shifts) may create significant headwinds for office landlords for decades to come. While there may be relative winners and losers in this scenario, we hold that office valuations do not reflect the new reality for the sector – particularly in dense gateway markets like New York City.

Executive Summary

Five Structural Shifts

❶ Work from Home (WFH) Trend

COVID-19 has normalized remote working and proven viable to employers. Experts believe reduced in-office work may cause office space demand to decline by 10%-15%.[1]

IMPACT ON OFFICE DEMAND: NEGATIVE

❷ Density Lifestyle Shift

COVID-19 and social distancing requirements may reverse decade-long trends towards denser office space and move towards a less-dense "horizontal" office environment.

IMPACT ON OFFICE DEMAND:

NEGATIVE FOR HIGH-DENSITY VERTICAL

POSITIVE FOR LESS-DENSE HORIZONTAL

❸ Office Employment Rate

There have been mass layoffs and unemployment in the COVID-19 environment. The pandemic will not be permanent, but it has created a recession and may have a lasting impact on office space demand.

IMPACT ON OFFICE DEMAND: NEGATIVE

❹ Tenant Shift to Lower-Cost Environments

Financial and non-financial costs to the employer and the employee will create winning and losing markets. Financial (high vs. low taxes); health/safety (old/crowded vs. new/social-distanced); difficulty (high vs. low-regulation); quality of life (cost of living).

IMPACT ON OFFICE DEMAND:

NEGATIVE FOR HIGH-COST MARKETS

POSITIVE FOR LOW-COST MARKETS

❺ Increased Landlord Spending for Tenant Retention

For years, office landlord costs have increased to 45% of NOI.[2] Tenants may require improvement packages. Most office buildings may require CAPEX investment to reconfigure the space to meet post-COVID requirements.

IMPACT ON OFFICE DEMAND: NEGATIVE

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1 Green Street Advisors: "Office Insights," 6/30/2020.

2 NCREIF

NOTES: Not all office real estate may face the same headwinds. "B" property in high cost areas may face the most headwinds. Additionally, valuations for office real estate are near all-time highs and growth near all-time lows, as measured by capitalization rates (cap rates) and same store NOI growth. Both are at or near levels seen during the global financial crisis of 2008-2009.

❶ Remote Working and Work from Home Trend

“We’ve proven we can operate with no footprint. Can I see a future where part of every week, certainly part of every month, a lot of our employees will be at home? Absolutely.”

-James Gorman, CEO of Morgan Stanley

In our opinion, the work from home (WFH) trend is not temporary. We, as a society, have had the technology for many office-based jobs to work remotely for years; however, it wasn’t until COVID-19 forced a mass WFH “experiment” that everyone realized WFH works better than we thought.

Corporate America has traditionally been suspicious of WFH and employees “goofing off” if they are not in the office. In addition to the revelation that WFH actually works, Corporate America is realizing they do not need to pay for so much office space and could reduce their cost structure if some of their employees did work remotely. Today, many companies are just starting to restructure to this new reality.

We believe that many jobs will never return to the office post-COVID, and many more jobs will leave the office over the next decade. COVID-19 has normalized WFH and most experts believe office demand will decline 10%-15% because of this trend.[3] This is a serious headwind for office landlords, in our opinion, as normal office demand growth is roughly in line with population growth (0.5%-1.0% per year).[4] This is a structural change, not dissimilar to how the long-term e-commerce trend has hurt mall and retail landlords’ ability to find tenants.

[3] Green Street Advisors: “Office Insights,” 6/30/2020.

[4] Source: World Bank 2018.

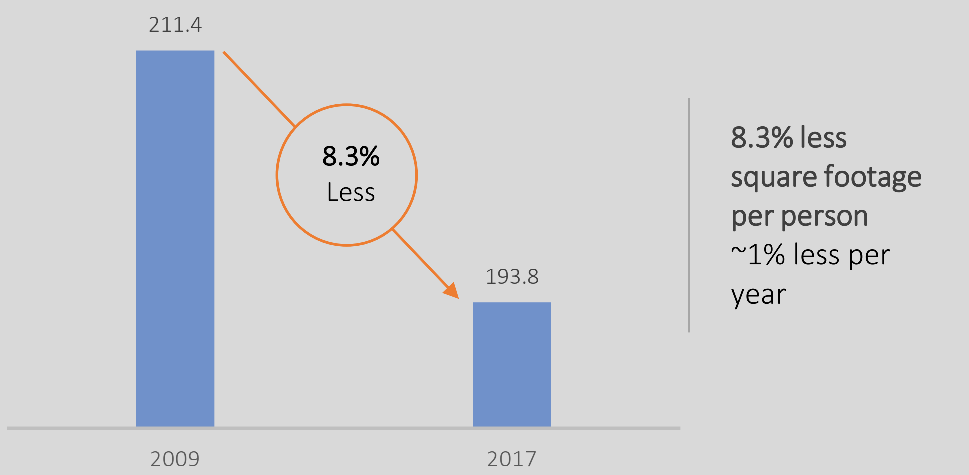
❷ Shift from a Dense "Vertical" Lifestyle to a Less-dense "Horizontal" Lifestyle

For decades, employers and employees have been squeezing more people into less office space each year. The last decade has seen a reduction of about 1% per year in office square footage per employee, which really adds up over multiple decades.[5]

FIGURE 1

Employers have been Squeezing more People into Less Office Space for Decades

OFFICE SQUARE FOOTAGE PER PERSON | 2009 VS. 2017



Source: Cushman & Wakefield: "The Rise of Open Spaces," February 21, 2019.

[5] Cushman & Wakefield: "The Rise of Open Spaces," February 21, 2019.

From the employee's point of view, they have traditionally moved to city centers, like New York City (NYC), for a host of reasons including job opportunity and mentorship, but also for the suite of amenities the city offered in the way of restaurants, bars, clubs, and entertainment venues. Traditionally, this suite of amenities balanced out the expense and lower quality of life (cramped living spaces, high cost of living, filthy subways, etc.) that came with the city.

During a pandemic, however, the costs and amenities of the city have fallen out of balance. With both the office and the amenities closed, many people feel as though there are no reasons left to live in the City.

From an employer's point of view, there is constant pressure to reduce cost. If employers can no longer reduce costs through densifying and desk-sharing, remote working is the new low-hanging fruit to reduce their office footprint. However, once sent home, the next obvious question for the employee is, "Why am I paying NYC rent if I don't have to be here for work and none of the amenities are open?" Similarly, the next obvious question for the employer is, "Why I am paying an employee NYC wages if they are not in NYC and don't have NYC's cost of living?" The end result is the recognition that office work is not bound by geography, and will move to greener pastures where quality of life improves.

We are already seeing a drop in apartment sales in NYC. According to CNBC, NYC apartment sales are at a 30-year low, down -54% year-over-year in Q2, and the median sale price has dropped -18% during that time, which indicates that hardly anyone is buying apartments in NYC.[6]

The physical constraints of the vertical lifestyle don't work under a government that is trying to enforce social-distancing; and even though COVID-19 may not last forever, it nonetheless creates a lingering impact on our built environment through building codes, government regulation, maintenance requirements, and a cultural change in social norms. We believe COVID-19 marks a turning point for office.

[6] CNBC https://www.statista.com/chart/22196/manhattan-apartment-sales-coronavirus/

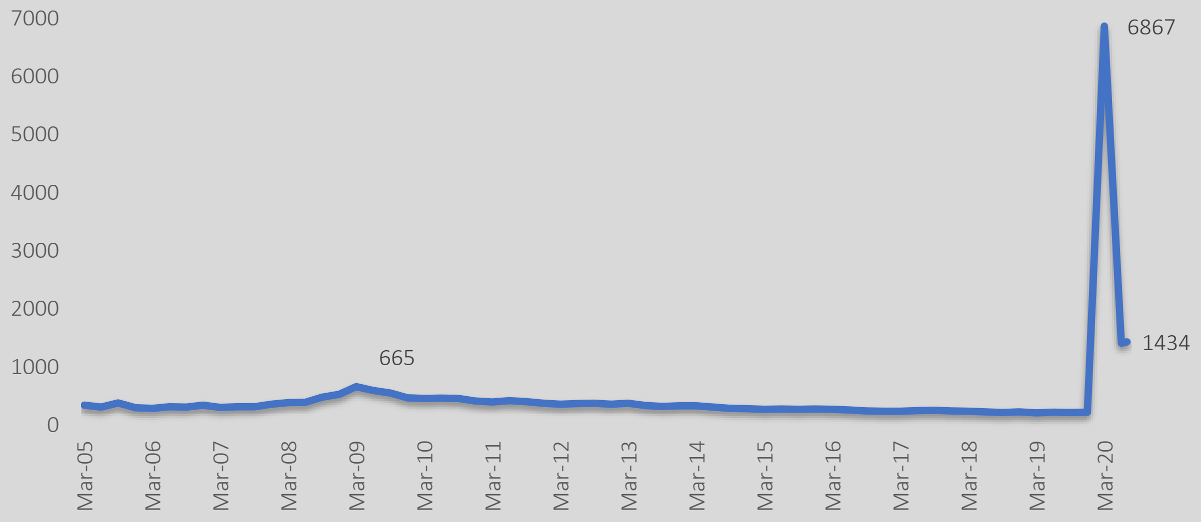
❸Negative Growth in Office Jobs

We are in a bad recession. We have unprecedented layoffs and businesses are facing difficult liquidity issues. We cannot predict how COVID-19 gets fixed or what arbitrary rules the government will force on business tomorrow. What we do know is that companies are not hiring, and this is not good for office landlords.

FIGURE 2

JOBLESS CLAIMS SOAR

US INITIAL JOBLESS CLAIM FILINGS PER WEEK IN THOUSANDS



Source: Bureau of Labor Statistics

❹Tenants and Employees will Gravitate toward Lower Cost Environments

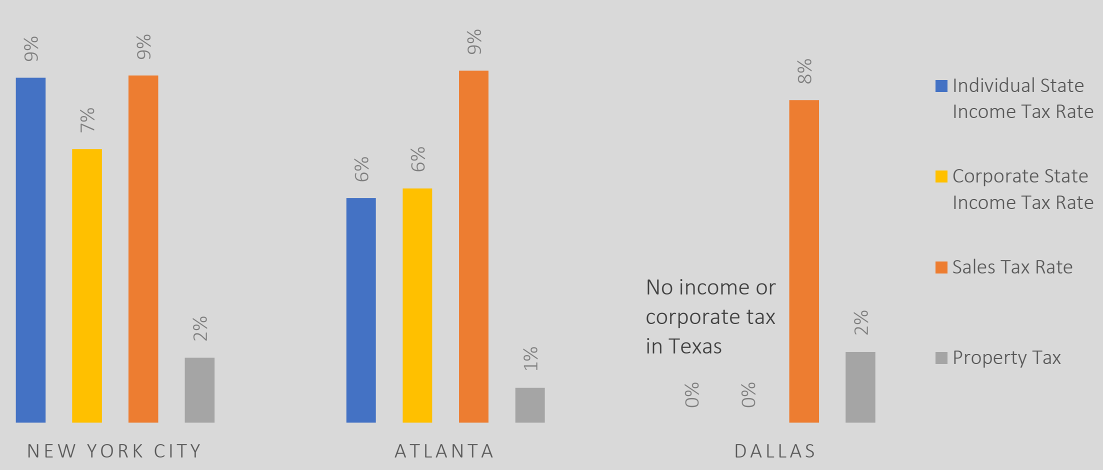
Both financial and non-financial costs to the employer and the employee will be a factor in determining winning and losing office markets:

- **Financial Costs (high vs. low-tax):** The states hit hardest by COVID-19 (New York, California, etc.) also have some of the highest tax burdens in the nation for both employers and employees (Figure 3). These states are also running budget deficits, suggesting there will be additional tax hikes in the future to cover the shortfall. There is already a net domestic migration out of high-tax states with more regulation to low-tax states with less regulation, and we believe COVID-19 will only accelerate that trend. Employers and employees fleeing markets like New York may significantly hurt office demand and rents in that market.

FIGURE 3

WORKING SMARTER, NOT HARDER

TAX RATES BY MARKET



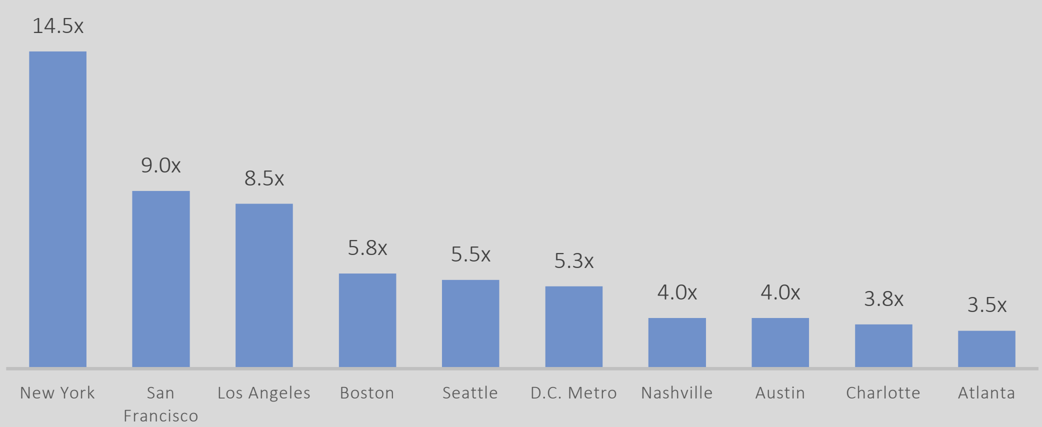
Source: smartassets.com

Home affordability is another financial cost that influences demand for office space. For a company to successfully recruit and retain employees, they must offer them an attractive quality of life, and home affordability is often a big part of that. Currently, homes in New York City are about 15 times the US median household income, while they are less than 4 times the US median household in Atlanta. Going forward, we believe the Sunbelt markets will see much higher job growth and office space demand growth than New York City (Figure 4).

FIGURE 4

MORE BANG FOR YOUR BUCK

MEDIAN HOME PRICE TO MEDIAN HOUSEHOLD INCOME RATIO



Source: Green Street Advisors as of June 30, 2020

- **Non-Financial Costs:** There are a host of other costs that are difficult to measure but which we intuitively know to be true. Americans generally prefer warmer over colder weather, and, over time, we expect the population to migrate from the north and northeast to the Sunbelt. From a health and safety "cost" perspective, we also expect some subset of the population to migrate from gateway cities to less urbanized areas post-COVID. We also expect employees to generally migrate from more-regulated to less-regulated regions for ease of use.

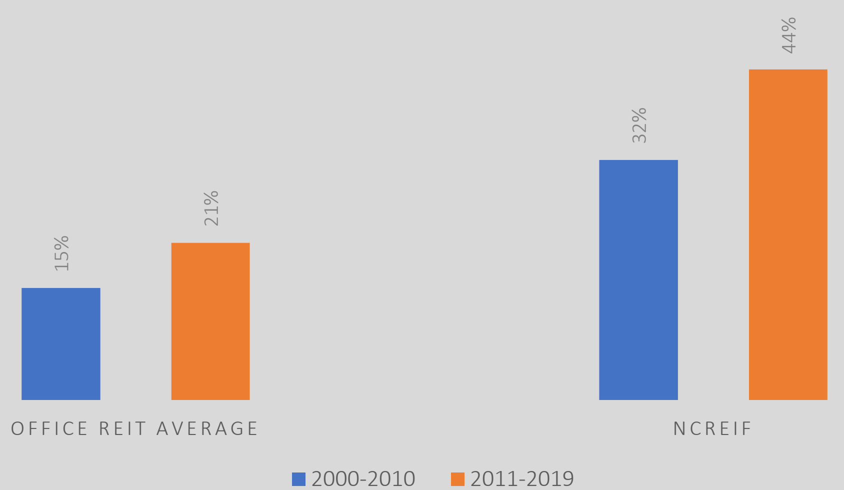
❺Increased Landlord Costs to Retain Tenants post-COVID

Capital expenditures in the office sector have steadily increased over the past two decades with landlords having to sacrifice capital and offer concessions to fill vacancy. We expect office landlord expenses (which includes tenant improvements, lease commissions, lease commissions, free rent, and maintenance costs) will continue to increase in the post-COVID environment as office landlords compete for fewer tenants. Green Street Advisors estimates that, in the public market, total capital expenditures (CAPEX) has increased from 15% to 21% of NOI in the last decade, and NCREIF estimates that in the private market CAPEX has increased from 32% to 44% of NOI.[7] This points us to the belief that office landlord profit will be eroded from both sides by declining revenue and increasing costs.

FIGURE 5

DECLINING REVENUE AND INCREASING COSTS FOR OFFICE LANDLORDS

OFFICE TOTAL CAPEX AS A % OF NOI | 2000-2019



Source: Green Street Advisors: "Office Insights," June 30, 2020.

[7] Green Street Advisors: "Office Insights," June 30,2020.

Summary of Relative Winners and Losers

The structural shifts of the office sector may benefit certain markets more than others.

⇧ Relative Winners

SUBURBAN/NON-GATEWAY MARKETS

Generally *more* business-friendly:
lower taxes, cheaper labor, lower cost of living, better fiscal health, and less regulation.

Remote workers are no longer tied to gateway markets, and may be able to achieve a comparable quality of life at a lower cost in non-gateway markets.

HIGHER QUALITY, NEWER BUILDINGS

Better amenities/overall building quality may hold up better in weak demand, but all office layouts could be subject to redesign post-COVID.

⇩ Relative Losers

URBAN GATEWAY MARKETS

Generally *less* business-friendly:
higher taxes, more expensive labor, higher costs, worse fiscal health, and more regulation.

Urban markets rely on density and public transportation, which are disrupted by modern social distancing requirements.

LOWER QUALITY, OLDER BUILDINGS

Lower quality buildings will be the first space to go unleased as supply exceeds demand.

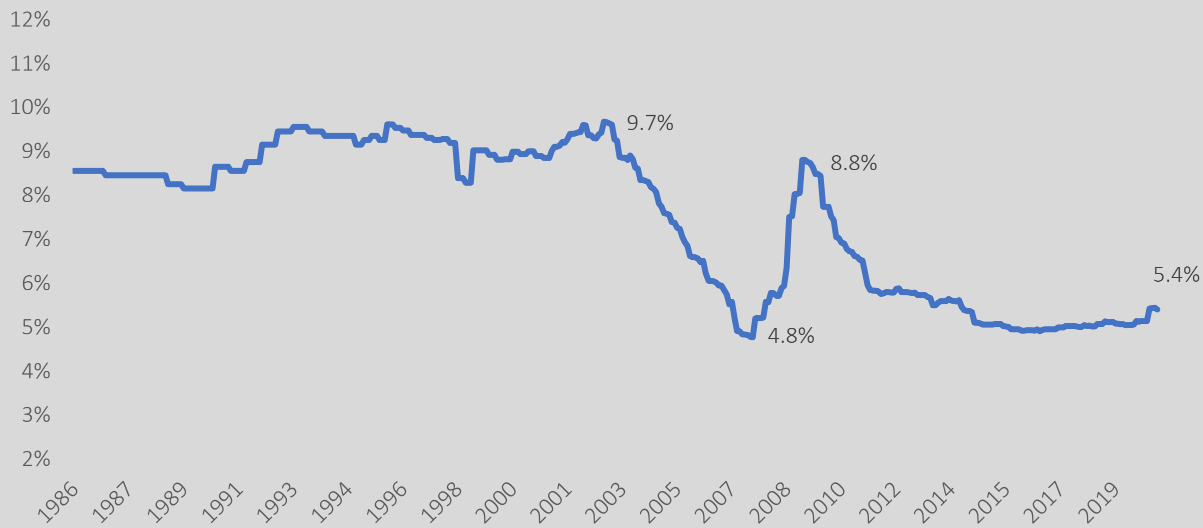
Valuation

As portfolio managers, we always look at valuation last. The first thing we ask ourselves is, "*Is this a good business?*" and the last thing we ask is, "*What is the valuation?*" We have already established that we do not believe office is a good sector to invest in, and it also strikes us as expensive given that cap rates are near historical lows (Figure 6).

FIGURE 6

HIGHER CAP RATES MAY MEAN LOWER INVESTOR RETURNS; CURRENTLY NEAR ALL-TIME LOWS

OFFICE SECTOR NOMINAL CAP RATE | 1986 - 2020



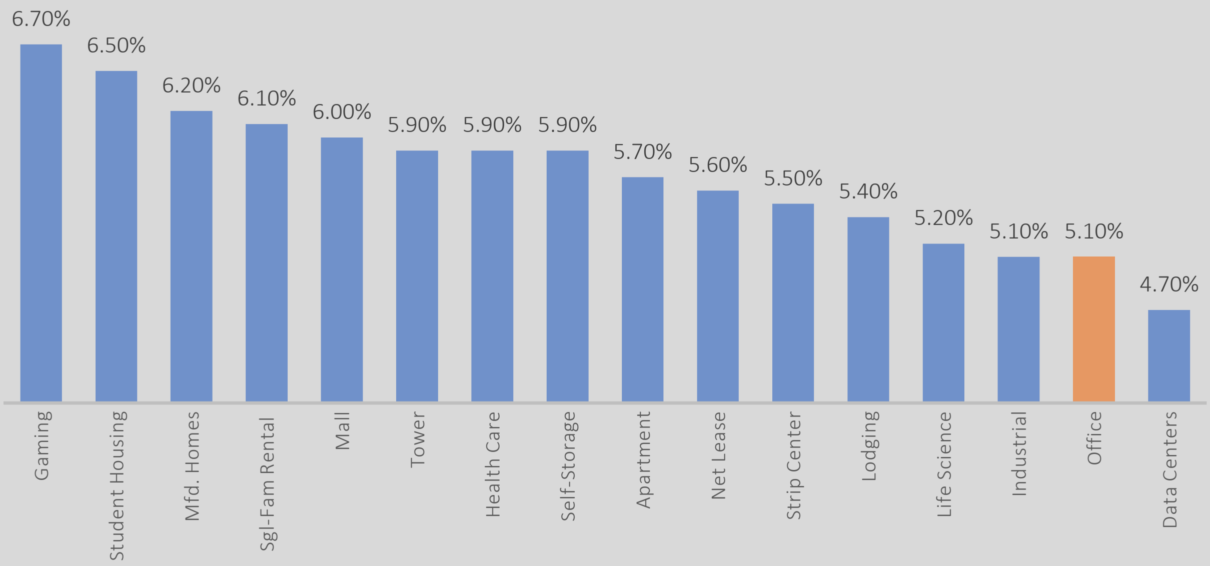
Source: Green Street Advisors as of June 30, 2020.

Relative to other real estate, office is priced to deliver lower returns than other property sectors. We believe the price is too high (and thus the return too low) to fairly compensate investors for the structural headwinds that may impair NOI growth (Figure 7).

FIGURE 7

OFFICE IS PRICED TO DELIVER LOWER RETURNS THAN OTHER REAL ESTATE SECTORS

REIT SECTOR EXPECTED RETURNS



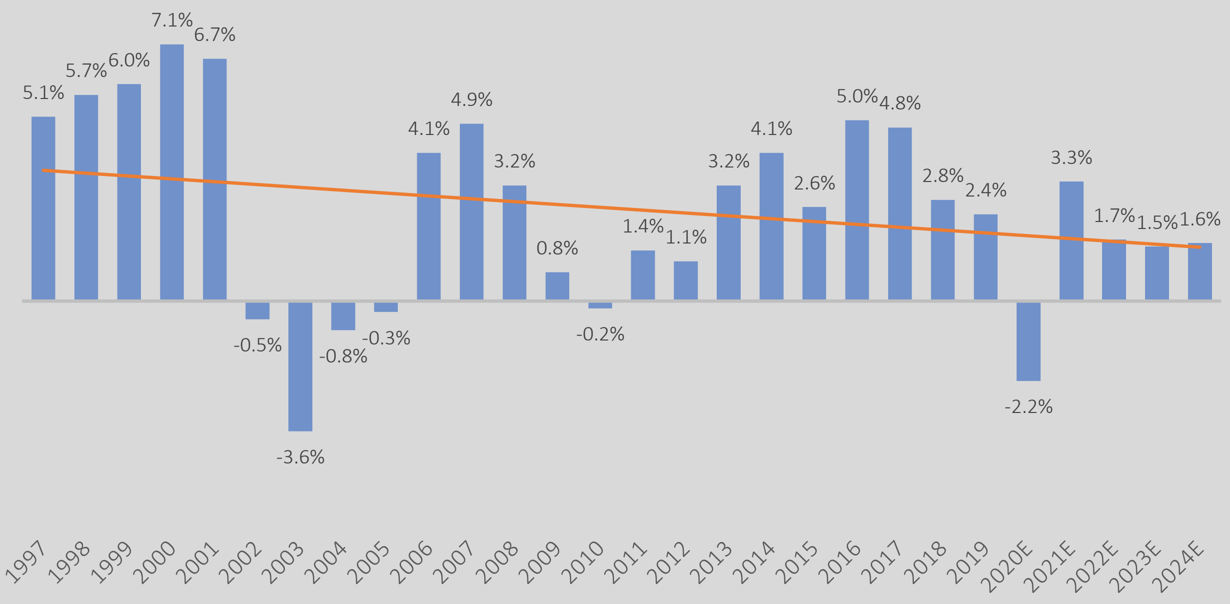
Source: Green Street Advisors as of June 30, 2020.

Same Store Net Operating Income (SSNOI), a measure of income generated from the same space year-over-year, is expected to be lower than in the pre-COVID era. Notably, the current drop in SSNOI is expected to be worse than it was during the global financial crisis recession (Figure 8).

FIGURE 8

REAL ESTATE INCOME IS EXPECTED TO BE LOWER THAN PRE-COVID ERA

OFFICE SAME STORE NOI GROWTH | 1997 - 2024E



Source: Green Street Advisors as of June 30, 2020.

The two main drivers of office valuation are (1) rent collected (net operating income, or "NOI") and (2) required rate of return (cap rate) to discount the NOI. In a hypothetical example, if office rents in NYC were to decline 20% and cap rates were to expand from 5% to 9% (this is the historical range – higher cap rates will be required to compensate investors for the loss of future NOI growth), the office building's value would drop by more than half (Figure 9)!

FIGURE 9

NET OPERATING INCOME AND CAP RATE ARE THE MAIN LEVERS THAT DRIVE REAL ESTATE VALUATION

Hypothetical Examples

Rent or NOI	Required Rate of Return Cap Rate	Stock Price
BEFORE $1.00	BEFORE 5.0% + 3%-4% expected future growth	BEFORE $20.00
AFTER $0.80	AFTER 9.0% + 0%-1% expected future growth	AFTER $8.89
RESULT Collected rents drop -20% *Recession, taxes, vacancy, bankruptcies, layoffs*	RESULT Rent growth rates decline, and cap rates increase about 4% *Structural shift to remote working and WFH*	RESULT **-56%** drop in office building value ⇩

Source: AACA

A Side Note on Recent Events

Another potential headwind for downtown office space is that crime is rising in the urban core of many gateway cities. According to CNN (on July 14, 2020), homicide rates were up 23% over last year in New York City and up 39% in Chicago during the last week of June and first week of July as compared to last year.[8] While we do not venture to guess what impact the "defund the police" movement will have, it is our opinion that any increase in violent crime may likely have a negative impact on demand for commercial real estate space in that market.

Crime may be one of the many metrics to keep an eye in markets like New York City going forward.

AACA's Philosophy

AACA's focus is investing in companies with portfolios that are as close to monopolies as possible. This is most prevalent when some subset (or all) of these characteristics is present:

1) The sub-sector of real estate is a monopoly, duopoly, or oligopoly
2) There are high barriers to entry for new supply
3) There are high barriers to tenants leaving/exiting buildings
4) The basic underlying economics of the tenant's business is healthy

We have found that when these four characteristics are present, companies in that space can generate favorable same-store net operating income growth over long periods.

In our opinion, office has zero out of these four characteristics. It has (1) thousands of institutional-quality providers, (2) low barriers to new supply, (3) almost no barriers to tenant exit, and (4) negative secular demand.

[8] CNN; https://www.cnn.com/2020/07/14/us/police-violence-defund-debate-trnd/index.html

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