Sponsored by MetLife Investment Management

# Office Update | How far it's come and where it's headed

## Office leasing is gaining momentum, but asset quality and demographics will dictate the speed of recovery

Commercial real estate has undergone significant demand shifts since the onset of COVID-19. There have been rapid and intense changes in performance across investment strategies. Residential and industrial properties have been clear winners for investors over the past two years. Demographic changes and the need for more space to work from home increased housing demand, driving up residential rents and investment returns. Similarly, an acceleration in e-commerce adoption made warehouse and logistics space a clear out-performer.

Office investments, on the other hand, have underperformed. Office occupancy declined as firms implemented remote working policies and downsized leased space. Lower occupancy reduces property income and has a secondary negative effect of causing prevailing market rents to fall as available space grows.

Despite these challenges, heightened by an uncertain economic outlook, we believe office occupancy is approaching a cyclical trough evidenced by recent positive net leasing activity. Additionally, average lease terms and tenant concession packages showed signs of a shift back to landlords, beginning in late 2021 and into 2022, according to MIM's analysis of lease data aggregated by CompStak, a market research firm. Even while we believe this is creating select tactical investment opportunities, investors have been slow to respond. We say select because understanding the pace of future office leasing, the drivers of medium-to-long term office demand, and geographical trends will be critical elements for avoiding risk while finding value in office investments.

**William Pattison, CRE**
Managing Director and Head of Real Estate Research & Strategy

**MetLife Investment Management (MIM)**

**Michael Steinberg**
Associate Director of Real Estate Research & Strategy

**MetLife Investment Management (MIM)**

**A look at future office demand**
Forecasting office demand used to be a straightforward exercise. There was a consistent relationship between employment growth in office-using job categories and office leasing activity. Pandemic-era remote work, however, broke that relationship (Fig. 1).

The difference between 2021 demand and the trend above suggests that remote working caused a 4% rise in office vacancy, or 150 million sq ft from the estimated four billion sq ft US office space. In other words, without remote working, we estimate that 12.8% of office space would be vacant, in line with the pre-COVID levels and historical averages, rather than the current elevated vacancy level of 16.8%.

While remote working was to blame for rising office vacancy in the past two years, we believe demographics will dictate the pace of the office sector's recovery in 2023 and beyond, as well as the types of office assets that we believe will outperform.

**Impacts of the war for talent**

Many economists were surprised by how quickly the unemployment rate recovered in 2021 and 2022, but we don't think they should have been. Government stimulus was certainly a factor, but we believe the demographic picture today vs. the last recession was also important.

As the economy recovered from the 2008 Global Financial Crisis, Millennials were entering the work force en masse, while the relatively small Silent Generation was reaching retirement age, creating a glut of workers. Today, conditions are reversed. Millions of Baby Boomers are retiring each year, while the relatively small Generation Z is entering the workforce. As such, the 2020s could exhibit persistently tight labor markets, and the 'jobless recovery' of 2009-2015 is unlikely to happen again following potential recessions that could occur during this decade.

This dynamic should create winners and losers within the office sector. Specifically, highly amenitized space will become an increasingly critical tool for employers seeking to attract and retain talent. This in turn could drive an accelerated recovery for the most desirable office assets (typically classified as "class A" or "Creative" office space), with amenities such as full service – and free – dining options, gyms, high quality air filtration, outdoor space, natural light from floor-to-ceiling windows, and high (12+ foot) ceilings with limited or widely spaced columns. Additionally, we believe there could be a widening premium for assets with walkable restaurants and access to main roads and public transportation.

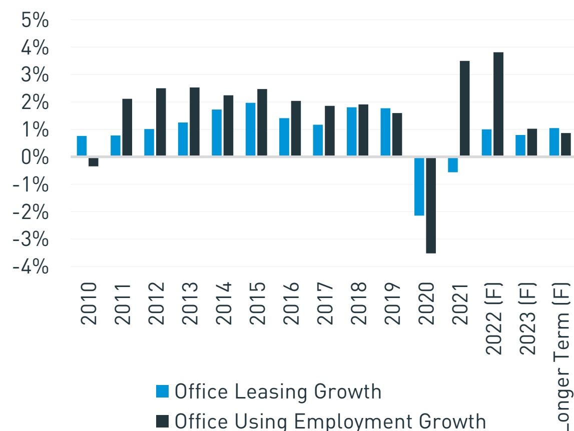
The rent premium between class 'A' and class 'B' office space was approximately 45% in 2019, as tracked by VTS. This has since increased to just above 50% and we expect it to grow to 60% by the end of the 2020s. However, we do not believe investors are placing enough of a discount on class B or C office space, or enough of a premium on class A and creative office space.

**Market targeting**

The change in leasing demand across markets is playing out as we expected at the onset of the pandemic. The markets that are performing well have had high population growth, limited risk from remote working (as we outlined in December 2020[1]), and a manageable amount of construction activity. Of the largest office markets in the US, 25 out of 30 have experienced an increase in rent and/or leased space

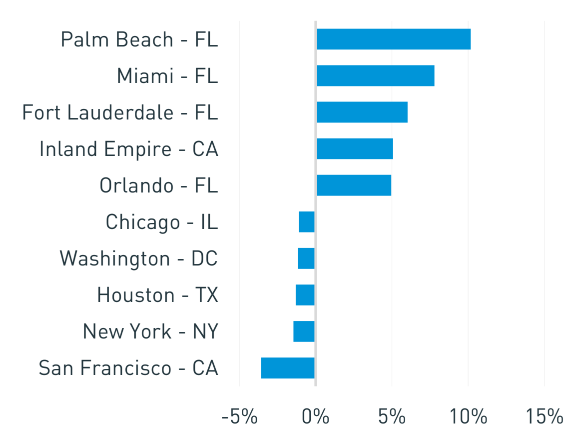
[1] *https://investments.metlife.com/insights/real-estate/pandemic-pitfall-short-term-forecasts-could-drive-mispricing-in-us-office/*

**Fig. 1: Office leasing vs. employment growth**




*Sources: MIM, CBRE-EA, Moody's. June 2022*

**Fig. 2: Office performance, 2021Q1-2022Q1**




*Source: MIM, Costar. June 2022. Performance measured as revenue per available foot*

over the last year.

Looking forward, we believe that several markets experiencing some of the most severe near-term challenges have the best long-term office demand drivers and could offer pricing opportunities in the current market. This includes stigmatized markets like San Francisco, as well as a handful of modestly better-performing markets such as Seattle and Denver, all of which have aggregated the talent that supports rapidly growing industries.

**Conclusion**

While vacancies have risen to near-record levels over the past two years, office demand is recovering. Downsizing office space has certainly occurred, but it has also been less practical than many companies predicted earlier in the pandemic.

Still, risks lie ahead, and investors should weigh those risks when considering pricing and return hurdles for new office investments today. Class B and C office space faces several negative headwinds in both the short and medium term, and many assets may need costly redevelopment into condos or apartments.

The war for talent is exerting a significant demand boost on the class A office segment, and we expect this to continue. If we are correct, we expect the highest quality offices to outperform most other real estate asset classes in coming years.

**William Pattison, CRE**, is a managing director and head of the real estate research & strategy team at **MetLife Investment Management (MIM)**. In this role, he works closely with MIM's real estate regional offices and portfolio managers to craft the strategic house view, project capital market trends, and develop investment strategies. As a member of the Investment Committee, William is responsible for reviewing and voting on all U.S. real estate acquisitions. Prior to joining MIM in 2015, William worked for ten years in the real estate group at Aegon Real Assets.

**Michael Steinberg** is an associate director of real estate research & strategy for MetLife Investment Management (MIM). He is responsible for development and maintenance of the team's quantitative research models, market forecasting, and communicating the team's investment strategies and economic outlook. Prior to MIM, Michael worked in both research and portfolio management capacities at UDR, a national multifamily REIT, and Reis, a leading real estate market research firm. Michael received a Bachelor's degree in economics from the College of the Holy Cross and an M.B.A. from Columbia Business School.

*This material has been sponsored by and prepared in conjunction with MetLife Investment Management (MIM) and is provided solely for informational purposes and does not constitute a recommendation regarding any investments or the provision of any investment advice, or constitute or form part of any advertisement of, offer for sale or subscription of, solicitation or invitation of any offer or recommendation to purchase or subscribe for any investments or investment advisory services. Subsequent developments may materially affect the information contained in this article. This article may contain forward-looking statements, as well as predictions, projections, and forecasts of the economy or economic trends of the markets, which are not necessarily indicative of the future. Any or all forward-looking statements may turn out to be wrong. Please visit investments.metlife.com for additional regulatory disclosures. All investments involve risks including the potential for loss of principal.*

# About MetLife Investment Management | Real Estate

MetLife Investment Management's1 Real Estate Group, with $110.8 billion2 in commercial real estate debt and equity assets under management, brings 145 years of experience across market cycles to deliver a collaborative, client-focused approach to your specific debt and equity portfolio needs. With 80+ senior professionals with an average of 24 years' experience, along with over 200 locally based real estate professionals in 11 regional offices around the world, we assess real estate debt and equity solutions by geography, property type and risk tolerances. Our seasoned professionals start by listening to your portfolio needs and work with you leveraging our powerful regional presence and longstanding industry relationships to seek attractive, long-term investment opportunities. We are institutional, but far from typical.

For more information, visit: investments.metlife.com/real-estate

---


**Disclosure**

This material is intended solely for Institutional Investors, Qualified Investors and Professional Investors. This analysis is not intended for distribution with Retail Investors.

This document has been prepared by MetLife Investment Management ("MIM") solely for informational purposes and does not constitute a recommendation regarding any investments or the provision of any investment advice, or constitute or form part of any advertisement of, offer for sale or subscription of, solicitation or invitation of any offer or recommendation to purchase or subscribe for any securities or investment advisory services. The views expressed herein are solely those of MIM and do not necessarily reflect, nor are they necessarily consistent with, the views held by, or the forecasts utilized by, the entities within the MetLife enterprise that provide insurance products, annuities and employee benefit programs. The information and opinions presented or contained in this document are provided as of the date it was written. It should be understood that subsequent developments may materially affect the information contained in this document, which none of MIM, its affiliates, advisors or representatives are under an obligation to update, revise or affirm. It is not MIM's intention to provide, and you may not rely on this document as providing, a recommendation with respect to any particular investment strategy or investment. Affiliates of MIM may perform services for, solicit business from, hold long or short positions in, or otherwise be interested in the investments (including derivatives) of any company mentioned herein. This document may contain forward-looking statements, as well as predictions, projections and forecasts of the economy or economic trends of the markets, which are not necessarily indicative of the future. Any or all forward-looking statements, as well as those included in any other material discussed at the presentation, may turn out to be wrong.

All investments involve risks including the potential for loss of principle and past performance does not guarantee similar future results. Property is a specialist sector that may be less liquid and produce more volatile performance than an investment in other investment sectors. The value of capital and income will fluctuate as property values and rental income rise and fall. The valuation of property is generally a matter of the valuers' opinion rather than fact. The amount raised when a property is sold may be less than the valuation. Furthermore, certain investments in mortgages, real estate or non-publicly traded securities and private debt instruments have a limited number of potential purchasers and sellers. This factor may have the effect of limiting the availability of these investments for purchase and may also limit the ability to sell such investments at their fair market value in response to changes in the economy or the financial markets

**In the U.S.** this document is communicated by MetLife Investment Management, LLC (MIM, LLC), a U.S. Securities Exchange Commission registered investment adviser. MIM, LLC is a subsidiary of MetLife, Inc. and part of MetLife Investment Management. Registration with the SEC does not imply a certain level of skill or that the SEC has endorsed the investment advisor.

This document is being distributed by **MetLife Investment Managem ent Limited ("MIML")**, authorised and regulated by the UK Financial Conduct Authority (FCA reference number 623761), registered address 8th Floor, 1 Angel Lane, London EC4R 3AB United Kingdom. This document is approved by MIML as a financial promotion for distribution in the UK. This document is only intended for, and may only be distributed to, investors in the UK and EEA who qualify as a "professional client" as defined under the Markets in Financial Instruments Directive (2014/65/EU), as implemented in the relevant EEA jurisdiction, and the retained EU law version of the same in the UK.

**MIMEL:** For investors in the EEA, this document is being distributed by MetLife Investment Management Europe Limited ("MIMEL"), authorised and regulated by the Central Bank of Ireland (registered number: C451684), registered address 20 on Hatch, Lower Hatch Street, Dublin 2, Ireland. This document is approved by MIMEL as marketing communications for the purposes of the EU Directive 2014/65/EU on markets in financial instruments ("MiFID II"). Where MIMEL does not have an applicable cross-border licence, this document is only intended for, and may only be distributed on request to, investors in the EEA who qualify as a "professional client" as defined under MiFID II, as implemented in the relevant EEA jurisdiction.

**For investors in the Middle East:** This document is directed at and intended for institutional investors (as such term is defined in the various jurisdictions) only. The recipient of this document acknowledges that (1) no regulator or governmental authority in the Gulf Cooperation Council ("GCC") or the Middle East has reviewed or approved this document or the substance contained within it, (2) this document is not for general circulation in the GCC or the Middle East and is provided on a confidential basis to the addressee only, (3) MetLife Investment Management is not licensed or regulated by any regulatory or governmental authority in the Middle East or the GCC, and (4) this document does not constitute or form part of any investment advice or solicitation of investment products in the GCC or Middle East or in any jurisdiction in which the provision of investment advice or any solicitation would be unlawful under the securities laws of such jurisdiction (and this document is therefore not construed as such).

**For investors in Japan:** This document is being distributed by MetLife Asset Management Corp. (Japan) ("MAM"), 1-3 Kioicho, Chiyoda-ku, Tokyo 102-0094, Tokyo Garden Terrace KioiCho Kioi Tower 25F, a registered Financial Instruments Business Operator ("FIBO") under the registration entry Director General of the Kanto Local Finance Bureau (FIBO) No. 2414.

**For Investors in Hong Kong S.A.R.:** This document is being issued by MetLife Investments Asia Limited ("MIAL"), a part of MIM, and it has not been reviewed by the Securities and Futures Commission of Hong Kong ("SFC"). MIAL is licensed by the Securities and Futures Commission for Type 1(dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activities.
For investors in Australia: This information is distributed by MIM LLC and is intended for "wholesale clients" as defined in section 761G of the Corporations Act 2001 (Cth) (the Act). MIM LLC exempt from the requirement to hold an Australian financial services license under the Act in respect of the financial services it provides to Australian clients. MIM LLC is regulated by the SEC under US law, which is different from Australian law.


[1] MetLife Investment Management ("MIM") is MetLife, Inc.'s institutional management business and the marketing name for subsidiaries of MetLife that provide investment management services to MetLife's general account, separate accounts and/or unaffiliated/third party investors, including: Metropolitan Life Insurance Company, MetLife Investment Management, LLC, MetLife Investment Management Limited, MetLife Investments Limited, MetLife Investments Asia Limited, MetLife Latin America Asesorias e Inversiones Limitada, MetLife Asset Management Corp. (Japan), and MIM I LLC and MetLife Investment Management Europe Limited.

[2] As of June 30, 2021. At estimated fair value. Represents the value of all commercial mortgage loans and real estate equity managed by MIM, presented on the basis of gross market value (inclusive of encumbering debt).


L0922025457[exp0924][All States] MIAL: L0922025456[exp0824][All States] L0822025446[exp0824][All States] L0922025459[exp0824][All States] L0922025492[exp0924][All States]

© 2022 MetLife Services and Solutions, LLC