For Office Owners, Generous Concessions Appear To Be a Winning Bet

Offering Free Rent and Tenant Allowances but Standing Firm on Asking Rent Projected To Result in a Quicker Recovery

As more areas lift mask mandates, more companies are expected to return to the office in some capacity, helping to bolster future demand. (iStock)

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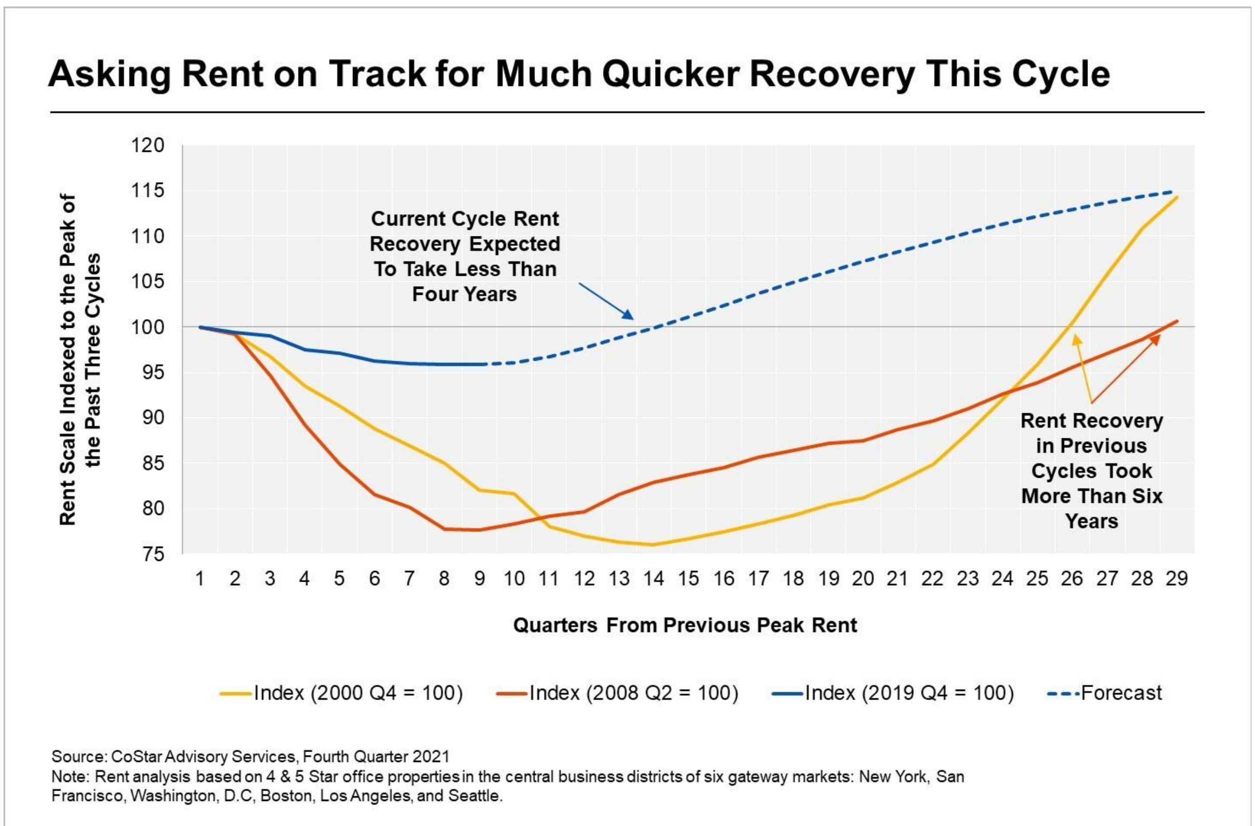
Two years into the mass remote-working experiment, owners of office property continue to face an existential threat to future demand. Contractual occupancy remains relatively stable, falling only 2.6 percentage points since the first quarter of 2020, similar to previous down cycles. However, according to managed security provider Kastle Systems, physical office occupancy remains challenged at just a quarter to half the level of pre-pandemic occupancy today versus two years ago, depending on the market.

Green shoots abound, however. The worst of the omicron variant now appears to have passed and many jurisdictions are deciding to lift mask mandates. As a result, many firms are growing in their conviction to bring more workers back to the office this spring, as recently reported by [the Wall Street Journal].

Most will not be resuming office life as it was pre-pandemic, instead electing to bring employees back on a hybrid schedule that incorporates some days in the office and some at home. The desire to prioritize collaborative in-office work, combined with a swiftly recovering labor market, should curtail tenants' ability and desire to shed space.

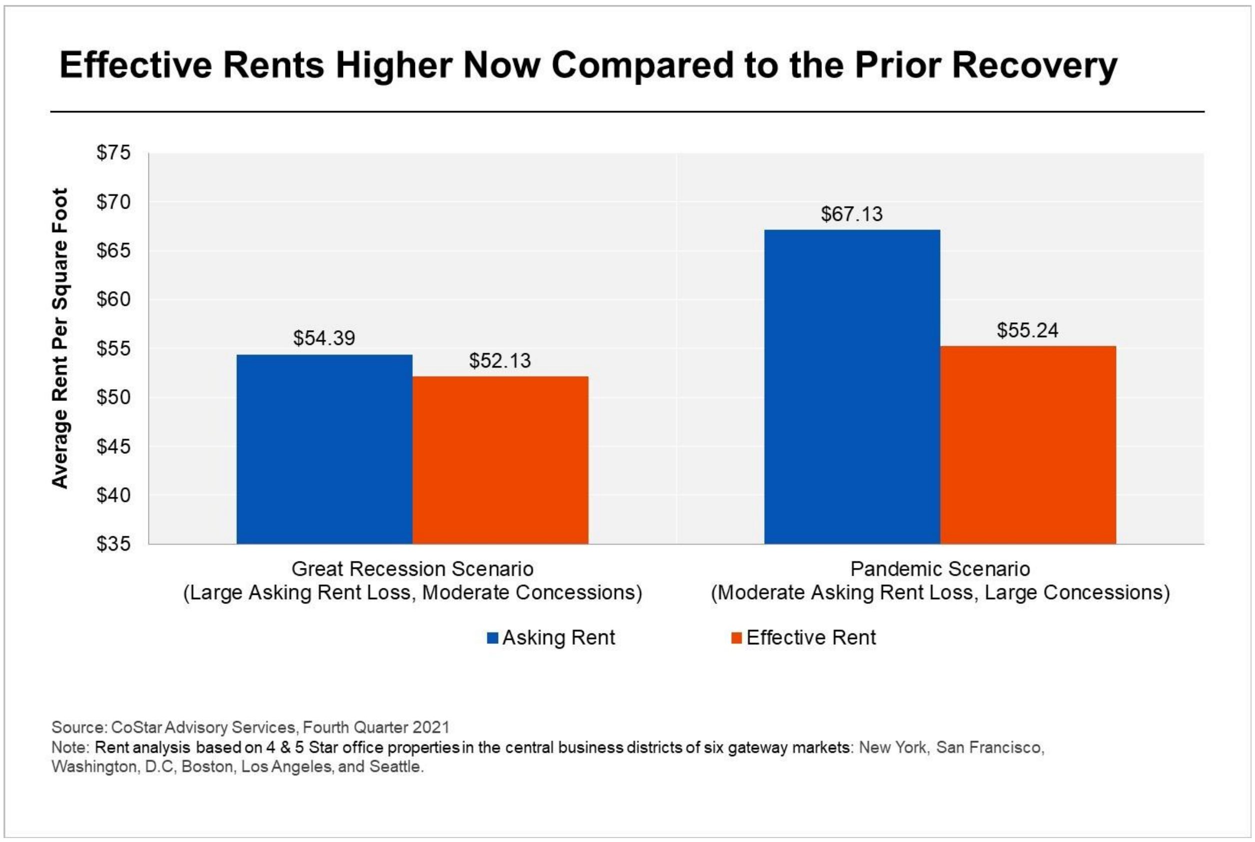
This changing focus for in-office work also has major implications for future office design, likely resulting in more communal areas and fewer cubicles. Changes to physical space cost money, and many landlords looking to lure new tenants or keep existing ones are offering aggressive concession packages as a result.

In the face of many unknowns, office property owners have prioritized keeping their buildings occupied. Aggressive concession packages, particularly in urban gateway markets, have been used to attract and retain tenants over the past two years. This strategy, in combination with tenant uncertainty over future space needs and a rapid recovery in office-using jobs, has resulted in far shallower declines in asking rent for office properties than during the previous two down cycles.



Effective rents remain higher than what the office market experienced during the previous cycle despite the substantial concessions. At the current pace of rent growth, CoStar projects that office rents will have fully recovered their pre-pandemic level in less than four years, a much shorter time frame than the more than six years it took for office rents to recover during the previous two cycles.

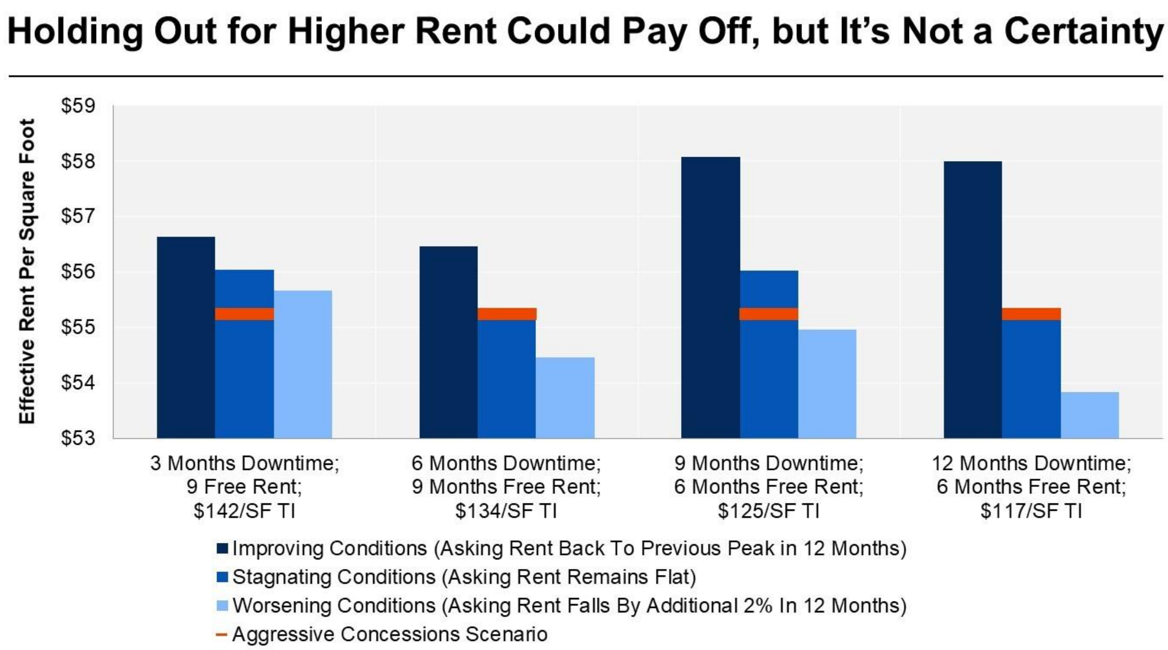
The heavy use of concessions during this recovery and the relatively modest asking rent declines are unique. Office owners offered more moderate concessions following the Great Recession, from 2007 to 2009, and asking rents fell more steeply. The analysis shown here compares two rent recovery scenarios with one using the prevailing lease terms during the Great Recession and the other using terms more common today, to see which approach leads to higher effective rents.



For the sake of comparison, assume both scenarios start with a peak asking rent of $70 per square foot and a $200-per-square-foot cost for the full tenant fit-out of the space. The Great Recession scenario uses a starting rent of $54.39 per square foot, equivalent to a 22.3% decline from the peak rent. In this scenario, landlord concessions include six months of free rent and $75 per square foot in tenant improvement allowances.

The pandemic scenario uses a starting rent of $67.13 per square foot, equivalent to a much shallower 4.1% decline from the peak rent. Landlord concessions are more aggressive, though, with 12 months of free rent and $150 per square foot in tenant improvement allowances. In both scenarios, rents are escalated annually by 3% and the term is 10 years. Even with aggressive concessions, the second scenario, with a much higher starting rent, ends with an effective rent that is 6% higher than the first scenario.

While a bitter pill to swallow, it may be wise for office landlords to lock in the certainty of occupancy now rather than chance fate. The market is showing signs of stability and it may be tempting to hold out for the prospect of a higher-paying tenant down the road. However, vacancy loss, inflating construction costs and an opaque near-term outlook make this tactic risky.



Source: CoStar Advisory Services, Fourth Quarter 2021
Note: Rent analysis based on 4 & 5 Star office properties in the central business districts of six gateway markets: New York, San Francisco, Washington, D.C, Boston, Los Angeles, and Seattle.

Using current conditions, the analysis next tests how effective rents could change over the next 12 months using various scenarios. If conditions continue to improve as expected under CoStar's base case forecast, landlords might want to wait to see if rent growth resumes and concessions burn off. However, if asking rents stagnate, or fall further, landlords may be left wondering why they didn't take a deal when they had the opportunity.

In a sensitivity test using 12 viable scenarios with differing vacancy downtimes, landlord concessions and asking rent assumptions yielded seven scenarios where landlords would have been better waiting for more favorable market conditions and five scenarios in which striking a deal today with aggressive concessions would yield a higher effective rent. Extended vacancy downtimes were tested at an additional three, six, nine and 12 months. Free rent was lowered to nine months in the two shorter extended downtime scenarios and further lowered to six months in the two longer extended downtime scenarios, rewarding landlords who waited out unfavorable market conditions. Likewise, tenant improvement allowances were lowered the longer the landlord extended the vacancy downtime. However, tenant improvement allowances were adjusted upward each quarter on a 6% annualized basis to reflect escalating construction costs.

Given the still uncertain times ahead, it's understandably hard for office landlords to pass up a deal today. The risk from lower occupancy doesn't appear to be worth the modest potential reward.

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