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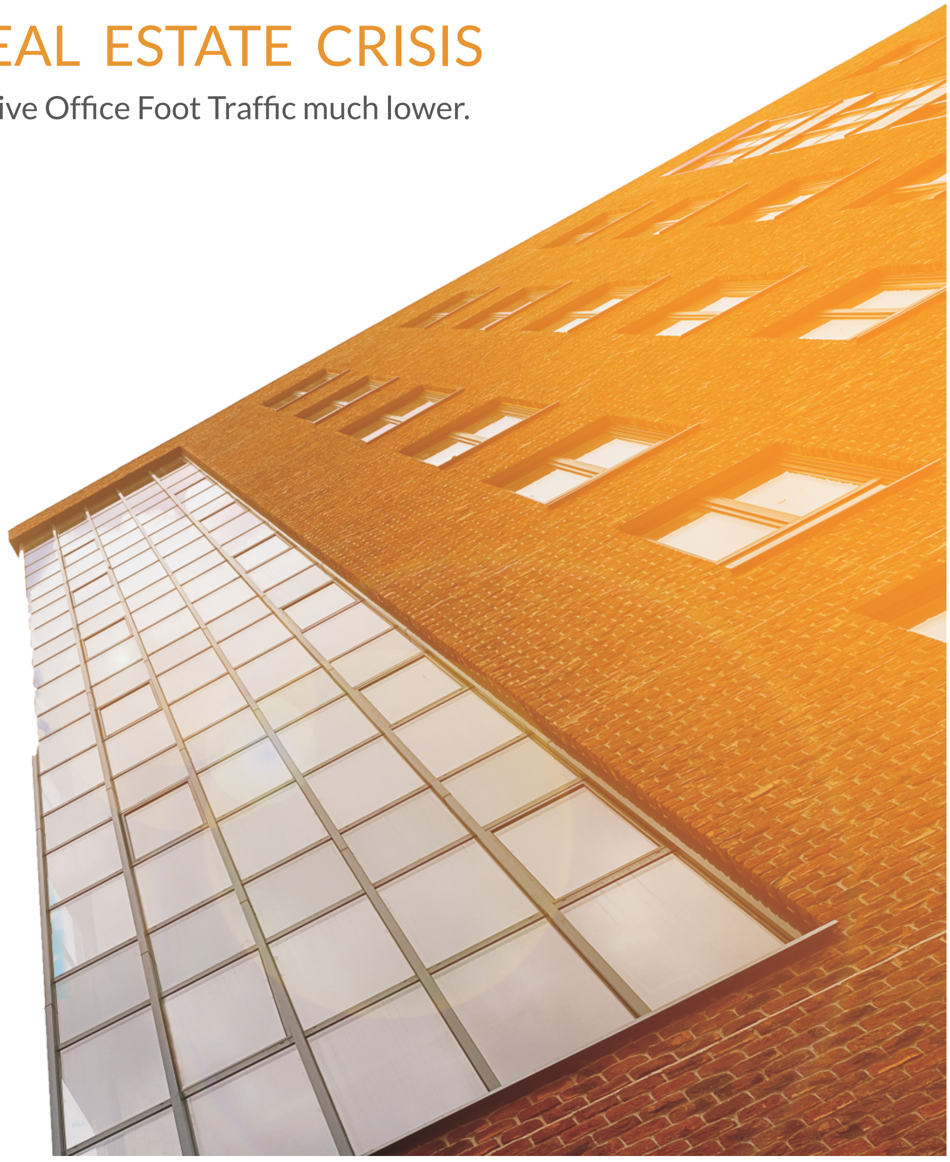
GETTING AHEAD OF THE LOOMING COMMERCIAL REAL ESTATE CRISIS

The impact of COVID-19 will drive Office Foot Traffic much lower.

by HEATHER JORDAN GERETY

May 18, 2020



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"I BELIEVE THAT THE MORE YOU KNOW ABOUT THE PAST, THE BETTER YOU ARE PREPARED FOR THE FUTURE."
by Theodore Roosevelt

When there's uncertainty of this magnitude, it is critical to look back over the past to determine if there were any trends and patterns that could help narrow down the amount of uncertainty and let us chart a path forward. Starting with a review of the following:

After reviewing the past, we can chart the path forward.

During this Covid-19 crisis, everyone wants a crystal ball that provides clues for how to move forward with regards to commercial real estate. We're inundated with projections, surveys, polls and models telling us what to do and how to do it. But given the absolute uncertainty we are all facing, today's forecasts will be as relevant to judging the future as last week's newspapers were for telling today's weather.

In the Age of Covid-19, it would not be surprising to say that commercial real estate is facing an unparalleled crisis in how to operate in the near- and long-term future. For example, Corporate Occupiers have countless numbers of leases that expire every month and they will need to make intelligent and informed decisions on whether to renew those long-term lease commitments. Given that renewals may not be a foregone conclusion, you could also see Real Estate Owners quickly have buildings with vacancy rates of 80% and up.

Many Owners, Occupiers and Service Providers have started critical planning and implementing for the immediate health and safety steps necessary to reopen offices, but have taken a "wait and see" opinion about longer term initiatives. Even in this crisis, experience tells us we can expect to see many opportunities that will come out of this recession.

Delaying decisions could leave Owners and Occupiers with millions of dollars stuck in unwanted and underutilized property. Owners and Occupiers, already under pressure to reduce costs, need new strategies and tools to come out ahead of this recession.

Success – thriving and not just surviving -- will come down to:

1
Closing or consolidating buildings with low Office Foot Traffic to reduce the financial burden on a company

2
Leveraging "Buildings as a Platform" to enhance brands and create communities

3
Moving to an "Employee Centric Ecosystem" from a one-size-fits-all "Building Centric Model"

THE STATE OF THE US OFFICE SECTOR COMMERCIAL REAL ESTATE

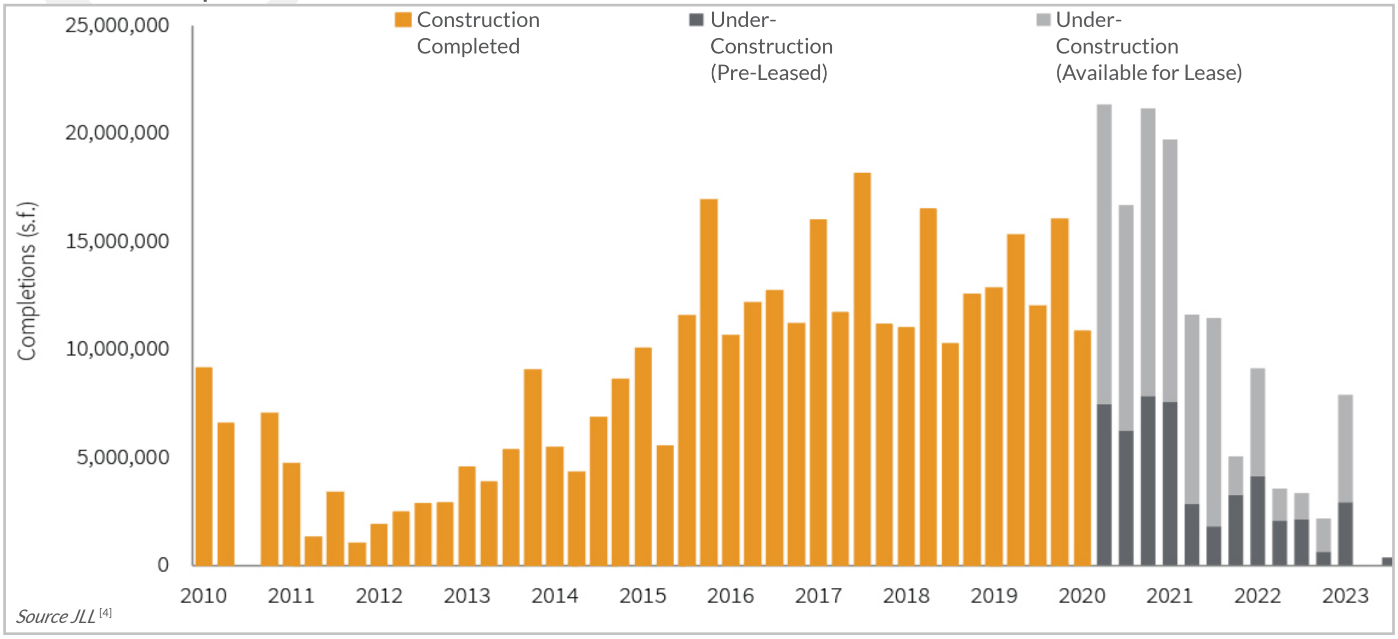
U.S. COMMERCIAL REAL ESTATE

COVID-19 has disrupted the commercial real estate industry and it's hard to believe the amount of change from last year. The market was strong: vacancy was at a record low, rents were growing, investor interest was bullish. Also, construction spending was still increasing, but considered well-balanced with the absorption rate.[1] The total size of all commercial real estate in the U.S. was estimated at $16.0 trillion, of which $2.5 trillion was in the office building sector.[3] You'd be hard pressed to say there were any concerns.

Conversely, some signs may have indicated possible hiccups—albeit not to the extent that we find ourselves today—such as the new supply of space becoming available in 2020 that is targeted for tech industries and co-working space because while the Tech industry was strong, finding talent was becoming increasingly difficult with an unemployment rate of 3.5%. Employing enough people to fill the surplus space was a concern. Also, the rapid growth in co-working space that was appearing could become unsustainable with the softening of investors' interest and a myriad of business problems that they faced. (for more details see pg. 9)

Today, in the 2nd quarter of 2020, a minor recession will be the best-case scenario in a post-COVID world. And while many economists predict the commercial real estate industry may recover by Q3 or Q4 of this year—or perhaps Q1 of 2021—their predictions are based on the industry's recovery time during past recessions. The current commercial real estate crisis is unprecedented, so previous timetables are not indicative of the future. To understand the issues the market is facing, the curtain will need to be pulled back to take a look at what is really happening in the office buildings.

Construction Completions from 2010 - 2024



Construction completions through the end of 2019 and planned construction completions for 2020 - 2024 that is either pre-leased or available for lease.

OFFICE FOOT TRAFFIC - DECLINING TRENDS AND PATTERNS

OFFICE FOOT TRAFFIC TRENDS

By the end of 2019, the commercial real estate market reports had a vacancy rate at a low 11.4% on average. Downtown vacancy rates were steady at 10%. San Francisco Bay Area remains the tightest of the nation's large markets, with a 6.7% vacancy rate.[1] What's missing from this type of market indicator is the Office Foot Traffic. We've seen Office Foot Traffic declining to an estimated 50% or less. This is an additional factor of building vacancy that went virtually unnoticed by the market reports as it is becoming common to have 'occupied' buildings with very few people working in them.

The downward trend of Office Foot Traffic is not a recent phenomenon. It has been occurring for the last 5-10 years (or more). Employees work remotely at client sites and at home. Additionally, employees are away from the office because of training, vacations and illness. Simply, they are not at the office.

> **Office Foot Traffic**
> This is the percentage of employees that are assigned to a building (or seats) compared to the number of these employees that come to the office each day.

> **Hidden Vacancies**
> It's the inverse of Office Foot Traffic. It's the amount of space (or seats) left vacant each day when the percentage of Office Foot Traffic is less than 100%.

After working with Fortune 500 companies' data over a few decades, our experience is that the declining Office Foot Traffic is not based on building location or formal work from home programs. The biggest indicator of Office Foot Traffic is whether the building serves as a Headquarters.

Before COVID-19, Office Foot Traffic for employees assigned to a space in a building averaged approximately:

- 50% (or less) for Headquarters building
- 35% (or less) for non-Headquarters building

This situation creates an increase in "Hidden Vacancies."

2019
OFFICE FOOT TRAFFIC
AVERAGING
50% OR LESS

HIDDEN VACANCY DATA IS KEY TO STRATEGIC PLANNING

MEASURING OFFICE FOOT TRAFFIC

The danger of low Office Foot Traffic is that it leaves the remainder of the space in buildings underutilized. The underutilized space is the inverse of Office Foot Traffic, known as Hidden Vacancy. For example: If the Office Foot Traffic was 35% of the employees, the Hidden Vacancy is the underutilized 65% of the space. This surplus of space is taking valuable resources that could be redistributed to provide new tools and services that supports mobile employees better.

The Hidden Vacancy factor has been measured for the past 15+ years, trending up every year. This was accepted as normal business in an upmarket, typically justified by the "war for talent." But in 2020, "the invisible enemy" arrived on our shores. Now we have a "new normal."

One way Owners and Occupiers can track and measure Office Foot Traffic and Hidden Vacancy rates by analyzing daily badge-in data for a building and comparing it to the number of employees assigned a seat or space in the building. These measurements focus on employees. Other people come and go in buildings (clients, contractors, building services, and more) but these visitors are typically related to the number of employees in the building.

Measuring Office Foot Traffic and Mobility is the most important measurements to track in the post COVID-19 world. Luckily, badge-in data is not the only way to measure, as there are many specialized companies, systems and tools to measure Office Foot Traffic and Mobility inside and outside of buildings. Companies are using multiple systems and tools such as sensors (camera or thermal), WiFi & Bluetooth devices, guest WiFi, food sales, badge-data, staffing systems and more to collect and track this data. Building owners and companies need to determine the best ways to collect the data while protecting the data and privacy of individuals.

The ongoing tracking of these measurements provide valuable insights to employee trends and patterns. For example, Fridays have the lowest Office Foot Traffic. The highest Office Foot Traffic happens on days with large company-wide presentations. These insights are vital in the post-COVID-19 new normal to understand and the usage of programs, tools and workspace, as well as other office and non-office services.

What people saying

62%
The Gallup poll (from May 1, 2020) says 62% of employees surveyed say they want to continue working from home as much as possible.[10]

38%
The Gallup poll (from May 1, 2020) says 38% of employees surveyed say they want to return to working at their office or workplace as much as they previously did.[10]

80%
In 2019, Owl Labs reported 80% of employees want to work from home at least some of the time.[9]

77%
Workplace Insight - May 2020 survey says, 77% of the workforce say they want to continue to work from home, when COVID-19 is over. That is a 132% increase.[11]

6%
Workplace Insight - May 2020 survey says, only 6% say they would not want to work from home in the future.[11]

60%
Workplace Insight - May 2020 survey says, 60% would be willing to give up their assigned desk at the office in exchange for the opportunity to work from home some or all of the time.[11]

HIDDEN VACANCY DATA IS KEY TO STRATEGIC PLANNING

WHY OUTCOMES OF THIS RECESSION WILL LOOK DIFFERENT THAN IN THE PAST

► **Office Foot Traffic was already at record lows**
Going in to 2020, the gradual increases in working from home (and Mobile working) over the years had reduced the amount of Office Foot Traffic. In the past 3-4 years, we've seen Office Foot Traffic drop at faster rates. The acceleration of working from home is the outcome of better mobile technology, better home broadband capability, flexible work schedules and more. Working from home has become more and more common, and more accepted, both in formal programs and informal arrangements between managers and employees.

► **Office Foot Traffic will go lower**
In January 2020, we learned that COVID-19 was highly contagious. Federal and state entities implemented mitigation methods to slow down the spread of COVID-19, to "flatten the curve" of infection. It required many employees to work from home and practice "social distancing." They made this decision to reduce the number of cases and deaths in the country, but it further impacted Office Foot Traffic, transforming buildings into "ghost towns." As the U.S. economy continues to struggle, it will force many Occupiers to consolidate their space and reduce their rental and overhead expenses.

"We're all living somewhere between threats and opportunities. The hope is to navigate through them and identify new paths that help all of us."
-John Hagel

► **Employees returning to the office prior to a vaccine**
Whether due to government restrictions, company policies and/or employee preferences, the extent to which employees will trust social distancing and sanitation in the workplace is unclear. If a vaccine is not available for a year or more, it could be months (or never) before some employees feel safe returning to the office.

► **When people feel safer going back to work**
Employees are unlikely to work in the office as they did in the past. In the future, working from home will likely be integrated as a portion of their work week (at least one to two days a week). Even some employees who once insisted they could never work from home will likely change their views post-COVID-19. And most employers will make some accommodations to make working easier for their employees. Companies could push-back on requests to continue working from home, but most working from home agreements happens organically between an employee and their manager.

► **With the growth of working from home**
We need to change how we work and the environments for work. The current situation provides a long-postponed opportunity to implement structural changes that will improve the workplace for employees, their companies, and the commercial real estate industry. This will not be easily implemented and will alter our post COVID-19 recovery time.

ILLUSTRATION OF THE PROBLEM

SIMPLE ILLUSTRATION OF THE PAST, TODAY AND FUTURE POSSIBILITIES FOR COMMERCIAL REAL ESTATE

To help clarify the problem at hand, this is a general illustration of what is possible when lease expiration opportunities are available (see below). If everyone came back to the office today, the Office Foot Traffic from 2019 will continue since this was already a normal pattern for employees working in the building. This is a known factor in determining the amount of square feet needed in the future. **We can start forecasting and planning with the 'known' 2019 Office Foot Traffic percentage for buildings.** For the reasons listed on the previous page, the Office Foot Traffic will continue to decline.

The real 'unknown' is "how much further will the Office Foot Traffic decline in the future?" There are numerous surveys and polls to reference (see call out box on pg. 4). These polls and surveys are a snapshot of employee's responses. From our experience, employee's responses after their first day back will change and their responses will change again after a week or two because:

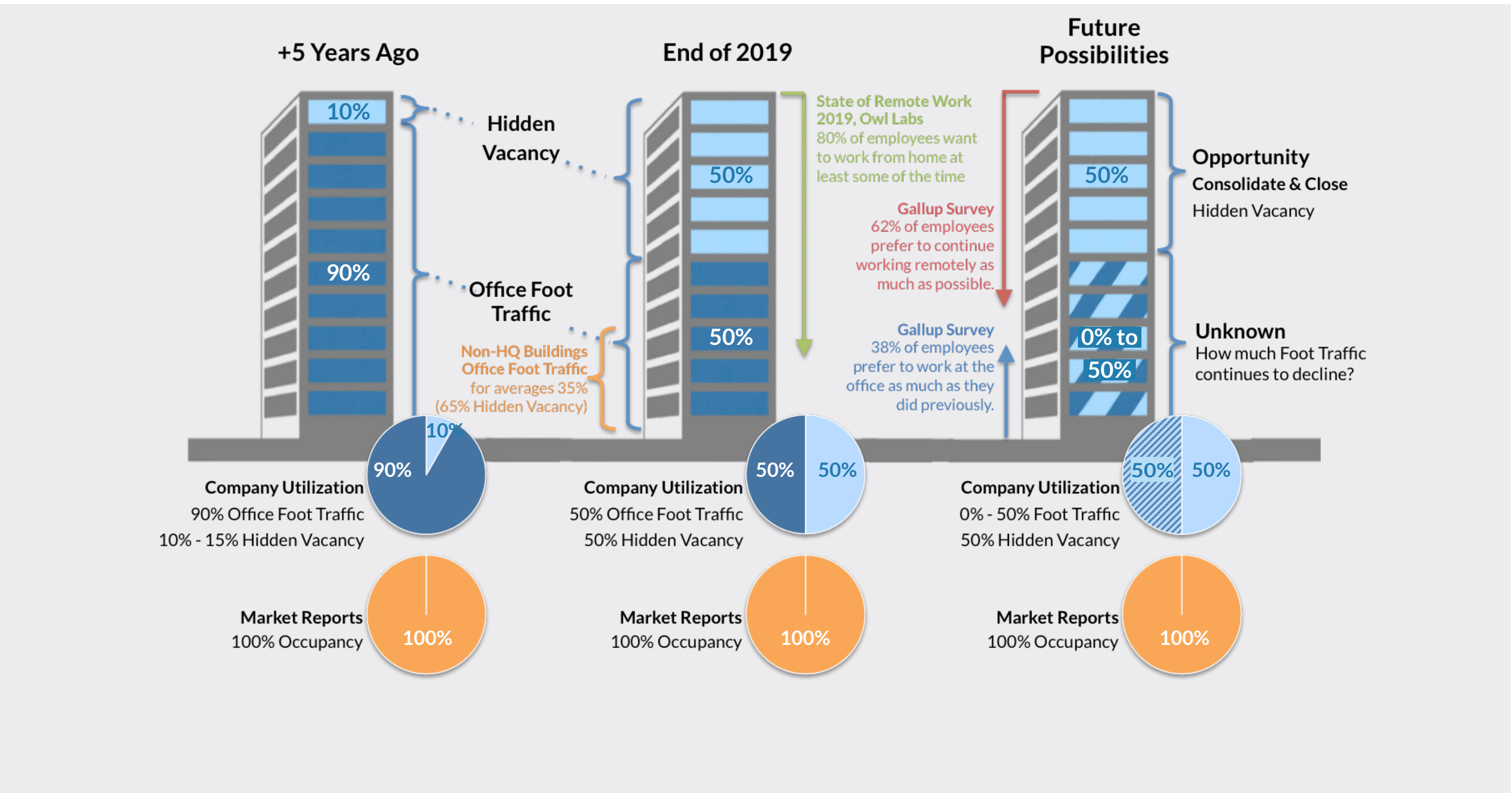
- Returning to the office may feel too burdensome compared to working from home because:
  - Commuting may feel like a waste of their time and unnecessary stress added to their day
  - Their experience with social distancing and safety requirements in the office may prohibit the benefits of being in the office.
- Excitement to see colleagues may only last for a couple of days.
- Work patterns and behaviors change and they may feel more productive from home.

From our experience and the reasons outlined, when buildings open the Office Foot Traffic could easily drop to 20% (or lower) in the buildings and remain low for the foreseeable future.

Notes:

> This illustration divides the Hidden Vacancy evenly on each floor. The reality is not this simple. Hidden Vacancy is typically scattered on each floor and changes each day.

> Consolidating space is challenging when accommodating all employees and organizations. With buildings closed, moving will be easier, but planning and packing will be more difficult without the employees present. Companies will need to balance these challenges with the opportunity to decrease their financial burdens of underutilized real estate.



STRATEGIES FOR TODAY AND GOING FORWARD

"YOU NEVER WANT A SERIOUS CRISIS TO GO TO WASTE. AND WHAT I MEAN BY THAT IS AN OPPORTUNITY TO DO THINGS THAT YOU THINK YOU COULD NOT DO BEFORE."

by Rahm Emanuel

While the full impact of COVID-19 remains uncertain, one conclusion is already clear: There is an urgent need to reinvent office buildings and real estate services to better support businesses and their employees better. Owners and Occupiers need new strategies and tools to come out of this crisis ahead.

Success – thriving and not just surviving - will come down to:

1

Closing or consolidating buildings with low Office Foot Traffic

Both Owners and Occupiers have a small window of time to reduce real estate before the market is flooded with vacant space. For the best opportunities in the market, quick assessments and decisions are needed to identify underutilized real estate, subleasing opportunities and lease expiration opportunities. **Time is of the essence.** Delays in planning and decision-making could be very costly.

2

Leveraging "Buildings as a Platform"

Building Owners will gain more vacancy in their buildings bcause of COVID-19, but they have the opportunity to expand beyond traditional brick-and-mortar office spaces to new platforms that enhance brands and create communities. In the short-term planning process, Owners can work with their Occupiers to determine the potential lease expirations and vacancy increases. It will take new ideas and innovative ways to lease and sub-lease more vacancy than expected.

3

Moving to an "Employee Centric Ecosystem"

Corporate Occupiers should move away from a one-size-fits-all "Building Centric Model" and toward an "Employee Centric Ecosystem" that provides employees with consumer-grade experiences that are independent from the employee's location. These changes won't happen overnight, but some changes can be implemented immediately to improve employee's current experience of working from home. Also, to help reduce anxiety as employees prepare to return to the office, consider new approaches to traditional brick-and-mortar spaces.

STRATEGIES FOR TODAY AND GOING FORWARD

MORE DETAILS FOR MOVING TO AN “EMPLOYEE CENTRIC ECOSYSTEM”

An **employee ecosystem** provides employees with consumer-grade experiences that are independent from the employee’s location.[8]

✚ Re-purpose buildings

Buildings are more than real estate. Transform spaces to be the “heart” of the company with new experiences, destinations and gathering places where the working community comes together to learn and discover the latest in business, tools, services and more.

✚ Bridge in-office and digital experiences

Create a seamless experience for employees with consumer-grade tools, services, interactions and information independent of employee location. Many tools have emerged to support this effort, but many are not available to employees to improve their ability to connect. Some are virtual reality (VR), artificial intelligence (AI), interactive tools, streaming technology and many more.

✚ Right-size your business

Flexibility and adaptability is better than bigger. When buildings are underutilized, the vacuum of space sucks staff energy and productivity. Smaller spaces can lower operating costs, while enhancing the employee experience.

✚ Look for new locations

The growing mobility of employees allows for Occupiers to locate new office spaces outside expensive metros. This can lower expenses for the company and the cost of living for employees.

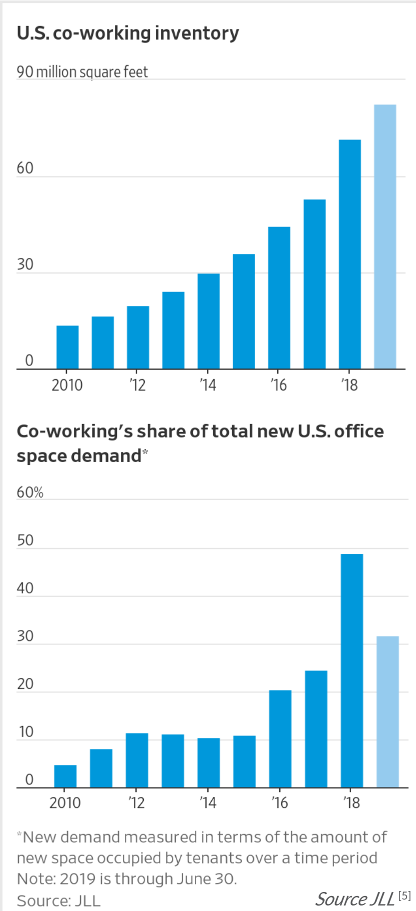
✚ Reinvent Real Estate Services

Services need to provide companies and employees with experiences in the office and outside the walls of buildings such as lifestyle elements (i.e. health and safety, nutrition, programs), work convenience (i.e. deliveries, printing), local retailers, etc. For these experiences outside the office, consider collaborations with municipalities, developers, homebuilders, retailers, transit authorities and more.

✚ Make it simple to work

Personalize and simplify the employee experience. Leverage new tools and services to consult, automate and support employees. Make working easier and more fulfilling. Give people good reasons to come to the office.

OTHER THINGS TO CONSIDER: THE IMPACT OF **CO-WORKING OFFICE** SPACE



Source JLL [5]

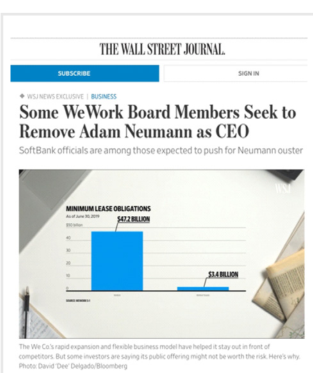
After the recession in 2007-2008, companies consolidated their spaces over the years, creating pockets of vacancy for many landlords. Companies that consolidated their space, still needed some flexibility in their portfolio to manage the ebbs and flows of business. One of the biggest recommendations to support Occupiers' need for flexible space is co-working office space (originally coined as "third spaces"). These spaces are made available on a rental or short-term basis to individuals, start-ups and small companies. They rent seats or small offices for a month-to-month fee or short-term lease. The most well-known co-working office spaces – is WeWork.

Co-working occupiers are subleasing property companies that take-on long-term leases and sublet the smaller portions of spaces to tenants with flexible short-term leases. Co-working office space has grown an average of 23% per year since 2010—with space nearing a total 90 million square feet—mainly located in metro cities such as San Francisco, New York, Chicago and London.[6]

There are concerns that the largest of co-working companies (WeWork) has expanded too fast. WeWork's website boasted of 123 cities with 846 locations. Their rapid growth makes them the largest private sector occupier of commercial real estate space in New York City and San Francisco. Last year, we got a glimpse into it's financials from their IPO filings. They reported
$47 billion in their lease commitments they've made for over 5+ years with only $3.4 billion in committed tenant leases (revenue).[2]

WeWork's imbalance of their financials will raise quit a few eyebrows and concerns, but a bigger issue is whether their space offerings will work in the future. Similar to corporate occupiers, WeWork has Office Foot Traffic challenges. It has expanded its business in other service areas, but their tenant subleasing business continues to be its main revenue source.

REASONS CO-WORKING'S BUSINESS SHOULD BE A SOURCE OF CONCERN.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Some WeWork Board Members Seek to Remove Adam Neumann as CEO
SoftBank officials are among those expected to push for Neumann ouster

The We Co.'s rapid expansion and flexible business model have helped it stay out in front of competitors. But some investors are saying its public offering might not be worth the risk. Here's why.
Photo: David 'Dee' Delgado/Bloomberg

The reasons co-working's business should be a source of concern:

- The "Pajama Rule:" It's more comfortable and less stressful to work from home. People are likely to prefer staying at home and working in their jammies if they can be as effective as they are at a co-working space or office building.
- In a down economy, start-up and small businesses that have short-term leases with co-working office space, will revert to cheaper real estate options such as working from home, meeting in coffee shops and using video collaboration tools.
- Larger companies are skeptical of "third spaces" because it's harder to secure company data in these environments. Additionally, monthly leases at co-working spaces are more expensive than letting employees work from home.
- With so many people working from home, there's less reason to go to co-working office space or another office building if you don't know who will be in the office that day. Would you go to a restaurant and sit all day hoping a friend will drop in?

KEY TAKE-AWAYS FOR COMMERCIAL REAL ESTATE TO EMERGE STRONGER

KEY TAKE-AWAYS

Commercial real estate has always faced issues when any type of recession hits the market. Because COVID-19 has created a commercial real estate crisis on the horizon, strategic planning processes needs to proceed quickly with the information that is known and what we've learned over the past few months. We still don't know the full impact on the economy and how much Office Foot Traffic will be reduced because of massive job losses and employees working from home, however there is a small window of time left to put strategies and tools in place to come out ahead. We've outlined our findings on where we think the biggest challenges lie:

- Growing need to reduce the financial burdens of a company's real estate
- Office Foot Traffic at record lows prior to COVID-19 with potential to decrease more
- Unnecessary Hidden Vacancies sprinkled throughout buildings
- Loosing opportunities to reduce real estate before the market is flooded with vacant space

With these factors looming, Owners and Occupiers need new strategies and new tools to come out ahead of this crisis.
Success – thriving and not just surviving - will come down to:

1 **Closing or consolidating buildings with low Office Foot Traffic** to reduce costs

2 **Leveraging "Buildings as a Platform"** to enhance brands and communities

3 **Moving to an "Employee Centric Ecosystem"** from a one-size-fits-all "Building Centric Model"

THE BOTTOM LINE

The impact of COVID-19 is issuing a challenge to commercial real estate professionals: Change and adapt their services for the impact of COVID-19's or hesitate and wither. The trends of declining Office Foot Traffic and increasing Hidden Vacancy at the end of last year reveals many more employees were working from home prior to COVID-19. It's not rocket science to conclude that post-COVID-19, working from home percentages will increase and cause a surplus of vacancy to the commercial real estate industry. Owners and Occupiers who track these measurements will reduce their uncertainty and quickly react to early occupancy and vacancy trends, as well as any change in overall employee behavior.

Commercial real estate can stay ahead of this looming crisis by working together to rise up to these challenges. Fast and creative thinking will help reinvent the purpose and future of office buildings and employee ecosystems. Owners, Occupiers and Service Providers can pivot their business with a renewed vision for commercial real estate and provide additional value to customers and the workforce in a post-COVID-19 world.

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Heather Gerety is an industry leader with over 20+ years' experience driving workplace transformations, portfolio strategy and occupancy plans. She has a specialization in facilitating change in complex organizations. Ms. Gerety is an accomplished manager with over 50+ million square feet of experience in work across major market sectors. Throughout Ms. Gerety's career, her primary focus is premium client services, innovative thought leadership and superior business performance results.

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