Black Swans and the Office Market:

A look back at major office market downdrafts and the opportunities that followed

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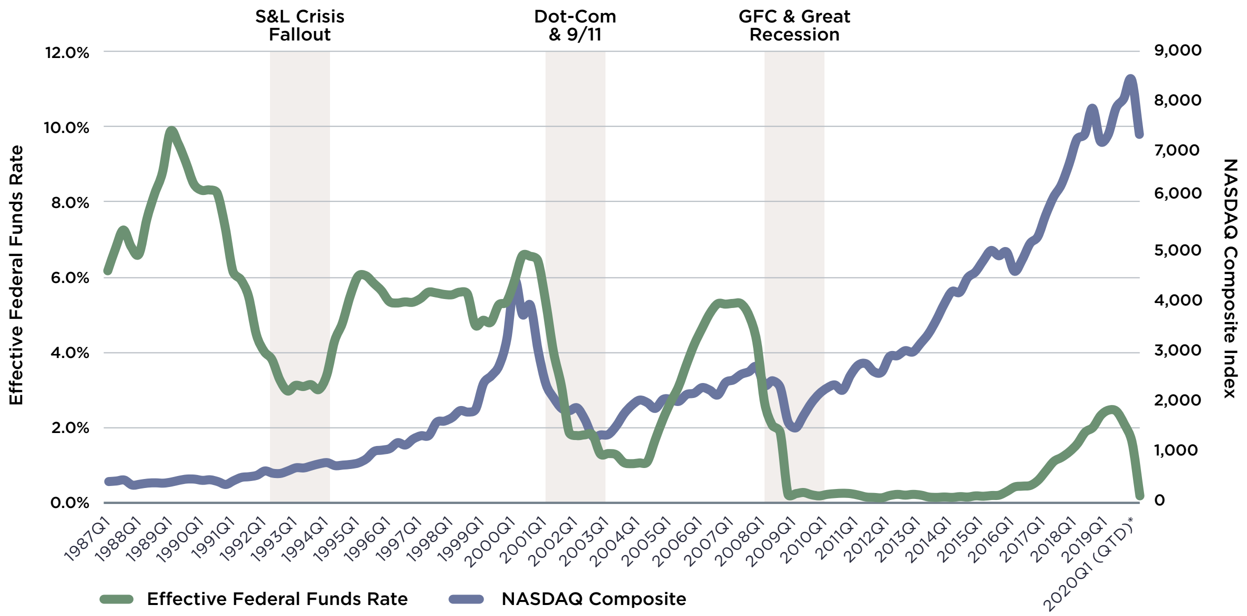
"Black Swans" are rare, major, and unpredictable events in the course of economic or world history that have potentially severe consequences. They are the pins which burst an economic growth bubble, often leading to increased unemployment, decreased consumer spending, and lower capital investments by small and large companies. Today we are watching slow-motion destruction in the wake of the most recent Black Swan event: the exponential spread of the COVID-19 pandemic across the globe.

While this one is different from 9/11 or the 2008 global financial crisis, given the pervasive fear associated with personal health and spike in unemployment, there are many likely scenarios here that will produce opportunities for office tenants and expose trend-curve changes once the turbulence subsides. Studying the recovery cycles from moments like these, we find common outcomes of opportunities for tenants in cost and space reduction, as well as increased lease negotiation leverage and term flexibility, that should provide relief for occupiers on the other side of this crisis.

Effective Federal Funds Rate and The NASDAQ Composite



*QTD 2020Q1 data available up to March 26, 2020

Downdraft 1992: The savings and loan (S&L) banking crisis

When I entered corporate real estate in 1988, it was not long before I witnessed the first economic shock of my career, one that would materially impact the office space market. The economy slipped into a recession from July 1990 to March 1991, after suffering a series of hard knocks: the 1989 S&L crisis, a spike in gas prices attributed to the first Gulf War, and the general run of the business cycle since the last downturn in 1983. Making matters worse, an inflation surge during 1988 and 1989 forced the Federal Reserve to raise the discount rate to 8.0% in early 1990 — restricting credit in an already-weakening economy. [See chart, p. 1]

Both gross domestic product (GDP) and job growth remained weak. Unemployment rose from 5.4% in January 1990 to 6.8% in March 1991, peaking at 7.8% in June 1992. [See chart, p. 4] Overall, an estimated 1.6 million jobs were shed during the recession. As inflation subsided drastically, the Federal Reserve cut interest rates to a then-record low of 3.0% to promote growth. Partly as a result of S&L lending, developers had built tens of millions of square feet "on spec." When factored together, the conditions produced an environment in which many landlords were forced to return highly leveraged properties to lenders. These lenders quickly wrote down the value of those assets and reduced rental rate expectations.

The outcome for tenants:

This cycle produced significant opportunity for tenants to right-size space, relocate to better premises, or renegotiate leases well in advance of expirations to reduce both footprint and rent.

In certain markets, landlords with newly down-valued assets executed leases at zero rent, simply amortizing concessions. This was the first golden age for tenant advocacy as we know it. Occupiers of office space obtained exceptional and unexpected results by resetting cost structures and improving their work environment. Some savvy tenants purchased space at a substantial discount to replacement value. Between 1992 and 1995, this activity in office space cost reductions collectively generated so much capital that it helped, in no small part, to finance the massive economic expansion between 1995 and 2000.

Downdraft 2001: The dot-com bubble burst and 9/11

The next Black Swan event to impact office space markets was the one-two punch of the dot-com bubble burst of 2000 and the September 11, 2001, terrorist attack. The dot-com bubble was the result of excessive speculation in internet-related companies during the late 1990s; a period of massive growth in the use and adoption of the Internet. Between 1995 and March 2000, the Nasdaq Composite Index rose 400.0%. First the dot-coms ran out of money, and then the 9/11 terrorist attack occurred, exacerbating the impact on the economy. The collapse of the equity market was complete in 2002 — giving up 78.0% of the gains made over the previous five years. Unemployment peaked at 6.0% in December of 2002.

The outcome for tenants:

This cycle produced greater opportunities for tenants with strong credit to drive favorable office leasing transactions, reducing costs, and reconstructing space in a more progressive way.

Many tenants applied the lessons of the pure densifying, cost-cutting approach of the 1992-1995 period and added the cool factor that emerged in the dot-com era. While many occupiers elected simply to execute short-term renewals, the strong-credit tenants with long-range vision were able to lock in long-term economics that would carry them through the next seven to ten years. The government temporarily offered tax benefits via accelerating 39-year depreciation to as few as 3 to 5 years. Tenants that elected short-term fixes found themselves faced with expiring leases in a rebounding office space market less than two years later.

Downdraft 2008: The global financial crisis and Great Recession

The Great Recession of the late 2000s was the next Black Swan event that materially impacted office markets and produced opportunities for tenants, although this crisis had different implications. After five years of debt-fueled growth, spurred on by loose monetary and tax policy, the moment of truth for borrowers – both consumers and business – arrived. U.S. household debt as a percentage of annual disposable personal income was 127.0% at the end of 2007, versus 77.0% in 1990. The housing bubble had produced the veneer of widespread individual consumer confidence, spurring unsustainable spending and borrowing by consumers. Simultaneously, careless regulatory conditions produced over-leveraged businesses, particularly in the banking and insurance industries, and on Wall Street. During 2008, three of the largest U.S. investment banks either went bankrupt (Lehman Brothers) or were sold at fire-sale prices to other banks (Bear Stearns and Merrill Lynch). These failures exacerbated the instability in the global financial system.

The outcome for tenants:

This cycle produced a mix of outcomes for tenants and businesses.

While the impact was particularly acute in New York City and financial services and mortgage centers like Orange County, California, it was less impactful on office markets in areas with a lower concentration of these industries. In the hot spots, rents fell dramatically as vacancies soared. In many markets, like Chicago, there was a plethora of short-term fixes, with a wait-and-see approach prevailing. Once again, select strong-credit tenants with long-range vision locked in low costs in those markets. Coming out of this cycle, the emphasis was less about transforming space utilization and more on reductions in space with limited to no capital expenditure.

2020: The COVID-19 global pandemic

Today's Black Swan event combines significant financial deterioration, both on an individual level and a corporate level, with personal safety and health risks in the forefront. It is far too soon to know where this will settle out, but it is safe to say that many office-space-using companies and service firms will be presented with a real opportunity to recast their real estate cost structure. With the end of the longest economic expansion in generations, many office markets across the country entered 2020 with very healthy, often landlord-favorable, fundamentals. As U.S. investors began to realize the likely impact of the COVID-19 crisis to the economy, the stock market shed over 25% of its value at a minimum and has traded below 37% of its peak value at times in the last two weeks. Interest rates have been dropped to effectively zero. While state and local governments scramble to try to blunt the blow, the fallout is clearly another Black Swan event, and office space tenants will be faced with pain but also opportunity.

Currently, we are seeing the following short-term impacts (March 27, 2020):

- COVID-19 is impacting all businesses. Businesses that are in high demand by an isolated, home-bound, white-collar workforce may be spared some of the brunt, but the impact will hit almost every business sector.
- Retail, travel, leisure and hospitality sectors are immediately seeing massive layoffs and many companies will not survive.
- The oil and gas industry is being devastated by the double whammy of a production war between Russia and Saudi Arabia and a drop in fuel demand as travel has effectively halted. Many small- and mid-cap energy companies will not survive the compounded effect of both events.
- Professional services firms are re-evaluating their workforces and making plans for workforce reductions and implementing other immediate and accessible cost reductions.

Continue to page 4 for the outcome for tenants.

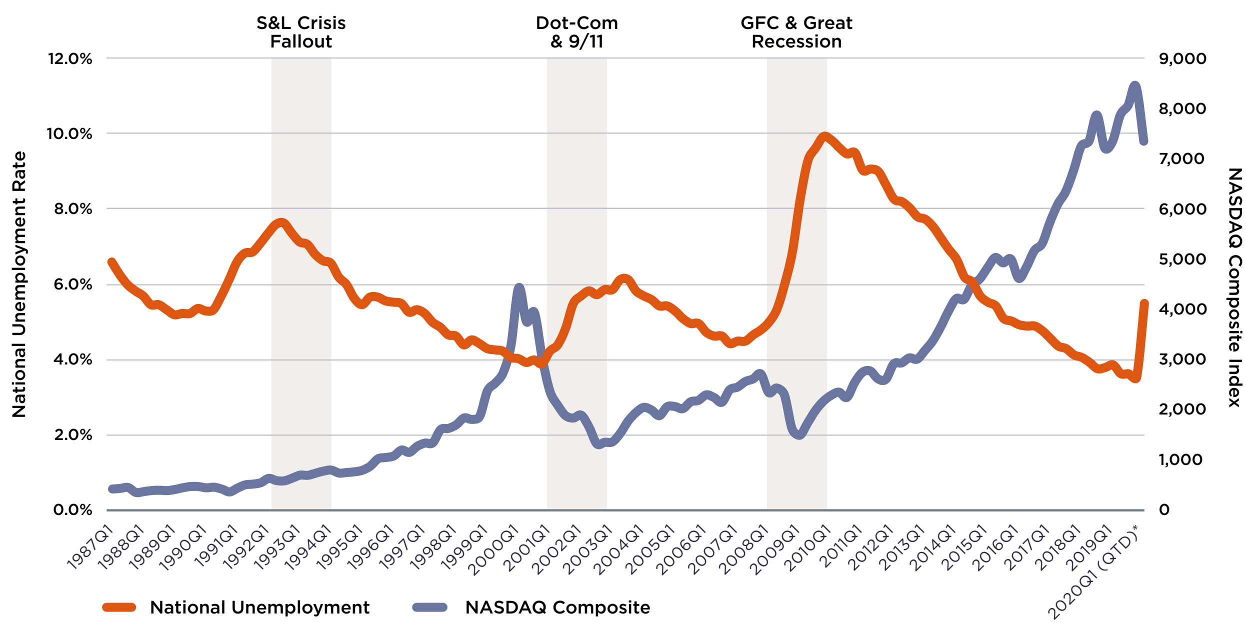
The outcome for tenants:

While it is too early to report on what office tenants will do in response to the circumstances at hand, under current trajectory, we believe the following are among the reactions we should prepare for:

- Metros and regions that have high concentrations of businesses hardest hit will see softening office markets. The supply of direct and sublease space will increase, providing tenants an element of leverage to open discussions with their landlords to find cost-reduction opportunities, while landlords in hard-hit markets will likely be forced to cooperate, given their own challenges.
- Hardest-hit markets will likely include Houston, Denver, Calgary, Miami, Orlando, Dallas, Oklahoma City, and Las Vegas.
- Federal government centers, like Washington, D.C., will likely be insulated, as the government typically grows in troubled times.
- Social distancing is producing consequences opposite to those anticipated by remote work advocates, as the desire for social interaction is rising and isolation realities settle in.
- Workplace trends of the last 10 years are being questioned, as community spaces and small, closely spaced workstation layouts may be re-evaluated.
- Office building operations are being evaluated and tenants will need to be more vigilant than ever about what landlords are or are not allowed to pass through to tenants.
- Tenants are looking closely at construction processes and hold-over provisions with a laser focus on force majeure issues and business interruption remedies and relief.

No one can know exactly how this post Black Swan recovery cycle will play out, though we do believe current conditions will produce an "all of the above" outcome. As business begins to resume and tenant activity unfolds, we will update this paper.

National Unemployment and The NASDAQ Composite



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