REMOTE WORK RESHAPES COMMERCIAL CONSTRUCTION

We really like being at home.

JOSEPH NATARELLI AND ANIRBAN BASU

The global outlook for office space was enormously positive during the years leading up to the pandemic. Although U.S. citizens and others had become accustomed to showing up in the office wearing increasingly casual clothing as the power suit–oriented 1980s faded further into the distance, the point is that they were showing up. The five-day workweek seemed firmly ensconced. From Monday morning until happy hour on Friday, office-using populations expanded as the United States shifted away from production activities and toward a service sector–oriented economy.

These dynamics kept owners of office buildings flush with rental receipts; developers aspiring to secure additional developable sites; and contractors happily installing windows, putting finishing touches on elaborate lobbies, and installing modern air handling systems. There was also work for those specializing in concrete, roofing, carpentry, painting, curtains, flooring, lighting, electrical work, furniture moving and storage, parking management, building security, maintenance, and an array of other categories.

Even a shortfall of available workers in the United States seemed to goad office development activity forward. The economic expansion cycle truncated by the pandemic was the lengthiest in U.S. history. Just before the economy shut down, the nation was recording 50-year lows in unemployment.[1] Employers were scrambling for talent, and one of the ways in which they appealed to workers with emerging knowledge was to offer the nicest, most amenity-rich office space. The result was a boom in Class A office space construction as employers — including in rapidly expanding technology and financial management segments — sought to attract top-notch professionals and recent graduates into their ranks.

It was true that there were indications prior to the pandemic that the global office

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market was overheated, but much of this could be explained away as aberrational. For instance, a report from early 2020 by CBRE — a multinational commercial real estate and investment service company — detailed activity in the Asia-Pacific region. The report noted that year-over-year net regional absorption had declined 19 percent.[2] However, the decline was largely attributable to a decline in China's Tier I office markets, which was at least in part the result of a burgeoning trade war with the United States.[3] At that time, CBRE analysts expected regional performance to improve, stating, "New office set-up is expected to increase in 2020 following China's opening of the financial sector to wholly-owned foreign institutions."[4]

The outlook at that time for the U.S. office market was similarly upbeat. CBRE's global chief economist Richard Barkham stated, "[2020] will bring deceleration on a few fronts, but this still is an expanding economy and a flourishing property market benefiting from a robust job market, solid consumer confidence and low interest rates."[5] He added that these positives would carry over into many of the nation's asset classes, such as office, retail, and multifamily units.[6] Census data indicated plentiful momentum, with construction spending in the office subcategory up 17.8 percent in January 2020 on a year-over-year basis.[7]

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Subsequent events would render all prior projections obsolete; such is the nature of forecasting. By now, everyone knows the story: When COVID-19 entered, office workers exited.

Enter COVID-19, exit normalcy

In February 2020, the number of people in the professional and business services category totaled 21.4 million.[8] This segment is a leading source of demand for office space, although there are others, including the financial activities and health-care segments. By April, 2.3 million jobs in professional and business services had disappeared.[9] However, this statistic fails to capture the most pertinent dynamic.

While many office space users retained their employment even during the worst of times, they began to work from home. At the pandemic's onset, some believed the crisis would interrupt the economy for two or three weeks, and normalcy would thereafter be quickly restored. Instead, the pandemic has likely altered our workplace behaviors for decades. Perhaps this would not have been the case had employee productivity tumbled as workers commenced working from home. Rather, productivity surged as office workers were freed from grueling commutes, idle chatter at water coolers, and the temptation to observe what others were wearing.[10]

As it turns out, the pandemic began after a period of remarkably slow productivity growth. U.S. productivity, which is typically measured as output per hour worked, grew more slowly between 2010 and 2019 than during any other decade of the post–World War II era.[11] Productivity in the business sector expanded at an average of 1.1 percent per annum, which is less than half of the 2.5 percent average annual growth registered from 1950 to 2009.[12] However, productivity rebounded across the entire economy in 2020, rising 2.6 percent compared with 2019's 1.7 percent performance.[13] With workers demonstrating that they could remain and perhaps even expand their collective productivity while working from home, employers became more accepting of remote work by employees who themselves became more demanding. A 2021 survey indicated that 68 percent of workers preferred working from home as opposed to in an office, although that number has since fallen.[14]

Compounding the office market adjustment is the fact that construction spending in the office subcategory reached a record high of $97.6 billion in February 2020, which was the month before the shutdowns caused by COVID-19.[15] Two months later, the figure had declined to just under $92 billion. However, that decline was likely attributable to supply side issues as opposed to demand for office space.[16] At that time, many stakeholders continued to believe that it was simply a matter of (brief) time before workers would flurry back to their offices. Indeed, the spending in the office category returned to a pandemic high of $94.9 billion by July 2020.[17] But then the unimaginable happened as remote work remained pervasive, and workers resisted efforts by employers to restore the status quo ex-ante. After July 2020, the spending in the office category would decline over the next 20 months before bottoming out at $84.3 billion in March 2022.[18]

There are other reasons to believe that remote work is here to stay beyond productivity data, which are subject to interpretation, and employee demands to stay at home in sweatpants. In an article published by WSP Global, a Canadian consulting firm, economist Jim Coleman notes that the pandemic has likely made remote work a permanent feature of the modern economy, if only to protect against the next possible outbreak. Coleman states, "The next time a coronavirus comes along, we know we need to move quickly to this model [of remote work], which means that it has to be in play — at least in part — most of the time."[19]

Storm clouds

This is not to suggest that there has been no return to the office. There has been a certain degree of normalization. Wall Street firms have been particularly eager to have workers come to the office more frequently, and other businesses, like Amazon, have followed suit. However, the move back to the office has been slower in the United States compared with many other parts of the world.

According to a recent article in *The Wall Street Journal*, occupancy rates relative to the pre-pandemic norm in places such as Europe and the Middle East have reached between 70 and 90 percent based on data released by JLL, a property services firm.[20] Rates are even higher in Asia, where occupancy ranges from 80 to 110 percent. This means that in some places, the number of office workers outnumbers pre-pandemic tallies.[21]

In the United States, however, occupancy rates remain low, at only 40–60 percent.[22] The geographic and demographic differences between the United States and the rest of the world help explain some of the differences in rates. U.S. homes tend to be larger than those found in Europe and Asia. Larger homes make allocating a defined space as a home office easier. That bolsters productivity and makes it easier for workers to balance work and home life by segregating workspace from areas supporting domestic activity. Homes in other nations, including Japan, are more likely to be multigenerational, making it even more difficult for working professionals to carve out space for dedicated remote work.[23] The vastness of the United States is also associated with lengthier commutes, which provides workers with even more incentive to demonstrate productivity from home as a form of time and effort savings.

However, if the distance to work were such a large factor, one would expect the densest office and population markets, including New York and San Francisco, to be relatively more resistant to remote work. That has not been the case. It took nearly two and a half years for New York City to recover the professional and business services jobs that were lost as a result of the pandemic.[24] For its part, San Francisco is wrestling with massive office vacancies. By late 2022, the city's vacancy rate had climbed to a record level — more than six times the pre-pandemic level.[25] At the end of September 2022, the city's office vacancy rate approached 26 percent, according to CBRE. At the pandemic's onset, it was around 4 percent. According to a Bloomberg article, workers "have been slow to return to the city's downtown, with weekly office utilization less than 40% of the pre-pandemic average."[26]

From the perspective of leasing vacancy space, there is another source of challenge: a shortage of workers impacting nearly every major U.S. economy segment. According to data from the U.S. Bureau of Labor Statistics, there were 10.1 million job openings as of April 2023, which is still well above pre-pandemic levels.[27] As of May 2023, the nation's unemployment rate was just 3.7 percent but much lower than that in many large metropolitan areas, including Baltimore, Tampa, Miami, and many others.[28] This has limited the ability of growing firms to add employees, further taking away from demand for office space.

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Rising rates and bank failures add to office segment woes

Lower occupancy has reduced revenues garnered by office building owners. Meanwhile, costs for maintenance and other personnel have skyrocketed, as have borrowing costs. All of this is negatively impacting cash flow and raising the risk of default. This is more apparent in certain markets than in others. CommercialEdge, an online marketplace that lists properties and spaces for sale or lease, released its national office report in late June, noting that the impact of remote work is still limiting market recovery. For example, sales prices in Los Angeles were down 43 percent compared to the previous year, falling from an average of $412 per square foot to $237.[29] In Chicago, asking rents are down sharply, with regional vacancy at nearly 19 percent, which is about 1.7 percentage points higher than the national average.[30]

Not only are vacancy rates rising while valuations are shrinking, but many office building owners will be required to refinance their debt over the next few years. Nearly $1.5 trillion of U.S. commercial real estate debt comes due for repayment by year-end 2025.[31] With banks looking to downsize their risk in the context of regional bank failures and growing scrutiny from investors and regulators, much of this debt is unlikely to be refinanced. Accordingly, the nation faces a wave of commercial real estate defaults over the next several years, many of which will presumably be associated with the office market. That, along with behavioral changes, will continue to frustrate the market for new office development while fueling a considerable amount of adaptive reuse.

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Looking ahead

Several construction segments stand to generate substantial amounts of work for contractors in the years ahead. Among these are manufacturing, health care, roads, bridges, schools, energy, water systems, and data centers. By contrast, office construction stands to be among the laggards, buffeted by remote work, slow labor force growth, elevated vacancies, and a lack of at-risk capital willing to support substantial new construction.

There is at least one additional consideration: artificial intelligence (AI). Many experts suggest that AI will be as impactful as the advent of the personal computer and the internet — this is perhaps true. However, the same technology threatens the livelihoods of many people in white-collar segments — the segments that are most critical to office leasing. Research from Goldman Sachs estimates that between 25 and 30 percent of jobs in the United States could have some share of their workload replaced by AI.[32] Administrative jobs are most at risk, with AI capable of automating 46 percent of tasks, followed closely behind by legal jobs, wherein 44 percent of tasks could be automated.[33]

Time will tell whether AI will create more jobs than it destroys. If history is any indication, the next generation of technological advancement will tend to broaden opportunity rather than diminish it. But as the last few years have demonstrated, it is best to expect the unexpected. ■

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