THE OUTLOOK

OFFICE

MIDYEAR 2021

More Aggressive Demand for Space Likely as Clarity Emerges

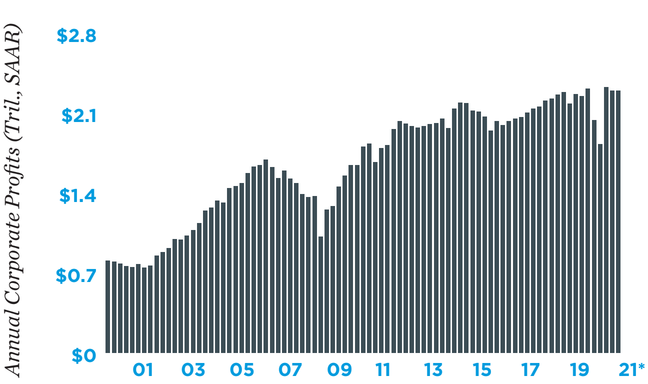
Economic improvement aids office sector. The U.S. economy has gained traction since inoculations became widespread. As most states peel back restrictions, the list of companies that have weathered the health crisis intact is growing and business profitability is rising. Corporate profits have stayed elevated after reaching a 20-year peak in mid-2020, while the cost of borrowing remains near historical lows, laying the foundation for company expansions in the quarters ahead. After delaying onboarding in 2020, many businesses are hiring once again. During 2021, roughly 6.5 million workers are expected to be added to payrolls nationwide, including more than 1 million in traditionally office-using sectors.

Hybrid work arrangements add complexity to space needs. More people becoming fully vaccinated is allowing employees to return to in-office schedules. A survey conducted the week ending on June 26 indicated that more than 67 percent of respondents were comfortable returning to the office, a marked improvement from January before most people had received shots. Companies are taking a more cautious approach. In May, the majority of firms surveyed planned to have offices fully open by the end of 2021. Some firms, however, have stepped up plans due to the rapid pace of immunizations. The health crisis and changing employee preferences have prompted a number of businesses to re-evaluate the structure and organization used to plan for workers who seek flexibility in their schedules. As a result, more companies are shifting to some form of hybrid option. Accommodating these varied desires complicates rather than simplifies space planning, however. Uncertain about the amount of floor space needed, some firms are penning short-term leases to hold onto the space until more informed decisions can be made, while others have put space up for sublease boosting availability. Clarity should improve as more workers return to offices in the second half of 2021.

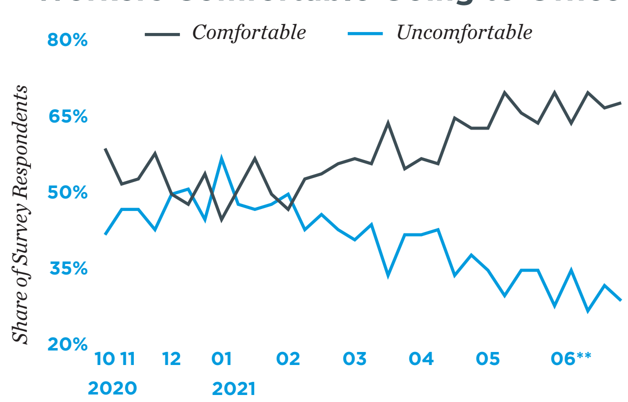
Updated amenities can enhance leasing efforts. Companies reassessing floor plates may pose challenges for office owners as more sublease space becomes available. Upgraded building features and amenities that cater to the post-pandemic desires of tenants and increased awareness of environmental, social and governance issues (ESG) can assist in leasing, however. More firms are now focusing on features that help provide for the health, comfort, safety and wellness of workers while assisting in achieving a work-life balance. Items such as improved security tracking and keyless entry are a couple of safety improvements. Health measures include touchless technology; infrared temperature sensing; improved air-filtration and circulation systems; air-quality monitoring; and UV lights. Employee well-being can be heightened through outdoor access and stress-reducing enhancements such as water features, yoga or meditation classes. Other amenities include open meeting spaces or conference rooms with adjustable room sizes.

Bright outlook for life science office segment. The search for a COVID-19 vaccine sped up an already growing level of demand for office space from biotech and pharmaceutical companies. Research and development employment in the life sciences surged 8.5 percent year over year in April and nearly 21 percent over the past five years. Overall U.S. employment declined 4.1 percent and inched up 0.7 percent during those same time frames. The new mRNA technology used in some of the coronavirus vaccines should bolster the need for additional workers and office space as the technology is used to fight other diseases. Buildings in large life science hubs that are equipped with lab capability or can easily be converted will benefit the most. The growth of biotech startups will also boost the need for space in lower-cost markets. Billions of dollars in funding from a variety of sources will drive demand in the segment over the coming years, attracting investors.

Corporate Profits Bounce Back

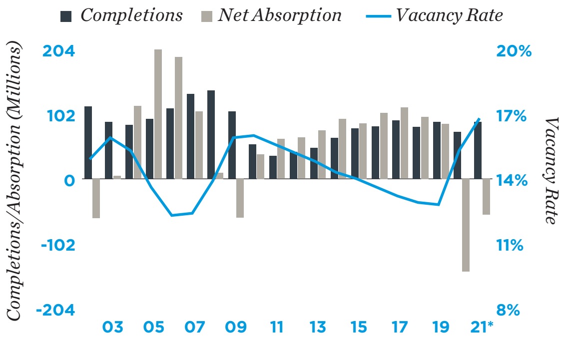


Workers Comfortable Going to Office

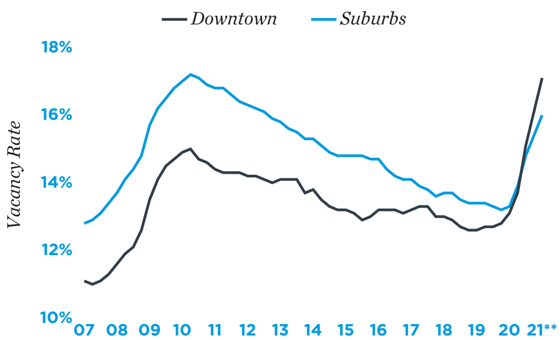


* Through 1Q
** Through week ending June 26, 2021
Sources: Bureau of Economic Analysis; Morning Consult

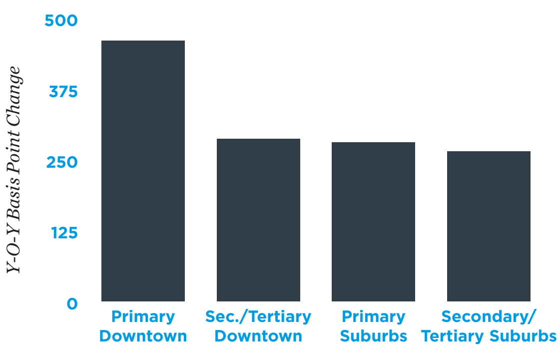
Supply and Demand



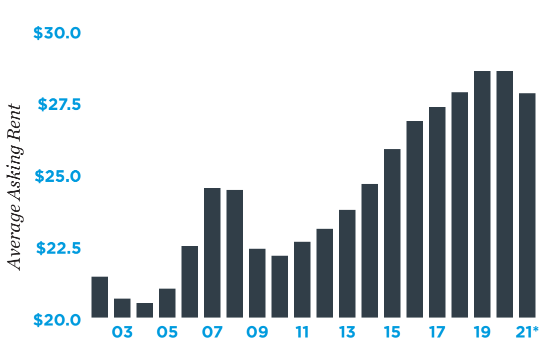
Vacancy in Core Rises Above Suburbs



1Q 2021 Office Vacancy Change



Rent Trends



* Forecast
** Through 1Q
Source: CoStar Group, Inc.

Office Fundamentals Improve, But Not Out of Woods Yet

Deliveries and subleases keep vacancy elevated. The health crisis posed major challenges to the U.S. office market over the past year as many companies sent employees home to work, emptying office towers. Due to the uncertain road ahead, many firms delayed leasing decisions just as new buildings begun before the health crisis were finalized. As a result, vacancy soared 310 basis point year over year to 16.0 percent in the first quarter, the highest rate since the financial crisis. Towers in the central business districts were especially hard hit as people stayed away from mass transit and densely populated urban centers. During 2020, vacancy in the urban cores rose above suburban vacancy for the first time since at least 2007, a trend that will likely hold in the coming quarters. Not knowing what was ahead, some businesses sought lower-priced alternatives in the suburbs to be closer to employees, while others decided to permanently work remotely and offer their space for sublease. San Francisco, for example, has posted the largest jump in availability, soaring 840 basis points year over year in March to 18.4 percent as more than 14 million square feet was vacated. Houston maintains the highest available rate at 22.9 percent, up 240 basis points annually. The metro was recovering from the downturn in the energy sector when the pandemic pushed the rate up even further. Looking ahead, as companies bring a majority of workers back to the office at least some days each week, leasing activity should improve, slowing the rise in vacancy this year.

New inventory poses challenges in select markets. Roughly 19 million square feet of office space was completed in the first quarter of 2021, raising the year-over-year sum to almost 71 million square feet, a 0.8 percent rise in inventory. This total is down from almost 92 million square feet added one year earlier, before the health crisis began. Construction is concentrated, typically in walkable urban settings, lessening the impact in the majority of cities. Just 11 major metros accounted for over half of the U.S. deliveries in the past four quarters, each receiving more than 2 million square feet of new space. Markets that welcomed the most inventory were led by New York with 6 million square feet, followed by Chicago with 4.3 million square feet and Dallas-Fort Worth with 3.8 million square feet. Looking forward, in 2021, corporations moving headquarters to high-growth southern cities including Atlanta, Charlotte and Austin underpin new supply in these areas, while expanding technology firms are generating a large portion of the development in Seattle-Tacoma. At the other end of the development spectrum, less than 320,000 square feet of new space is due in areas including Oakland, Cleveland and Riverside-San Bernardino, minimizing the overall impact on vacancy in these markets this year.

Increase in availability weighs on rents. The fourth consecutive quarter of negative net absorption cut the average asking rent for the nation by 2.6 percent to $28.23 per square foot in the opening quarter of 2021 as many operators expanded concessions. This is the first rate decline over an annual period since late 2010, driven by a 6.1 percent drop in the nation's CBDs to $37.84 per square foot on average. By comparison, the suburban average rent rose slightly during the past four quarters to $24.35 per square foot in March. There is wide variation among metros as well. Smaller cities with little new inventory and positive net absorption, including West Palm Beach and Riverside-San Bernardino, recorded rent gains of 2.5 percent or more since March 2020. The country's largest markets did not fare as well as businesses vacated towers in densely populated urban cores. New York City, hard hit early on in the health crisis, posted the greatest rent drop of 11.9 percent year over year to $55.61 per square foot, the lowest rate since mid-2015. San Francisco and Seattle-Tacoma were other metros posting rent reductions of more than 5 percent. Lower rates in trophy buildings should improve leasing activity this year as companies that made it through the pandemic seek better-quality locations.

Deliveries, Subleases Will Weigh on Operations This Year

2021 Forecast

U.S. EMPLOYMENT

4.6% Y-O-Y increase

- The nation is on track to add 6.5 million jobs during 2021, the highest annual growth rate in more than 30 years. This total is expected to include 1 million positions in traditional office-using sectors. Still, it will take into next year to fully regain all of the 9.4 million positions lost in 2020.

U.S. CONSTRUCTION

90 million square feet completed

- Completions in 2021 rise to the second highest level in 12 years, but this still represents only a 1.1 percent increase in inventory. Deliveries are concentrated in gateway cities and fast-growing metros in the South, minimizing the overall impact in most markets.

U.S. VACANCY

150 basis point increase Y-O-Y

- The increase in deliveries and additional subleased inventory being marketed will push availability to the highest rate since at least 2000. The vacancy rate climbs 150 basis points to 16.8 percent in 2021, a slowdown from last year's 250-basis-point jump.

U.S. RENT

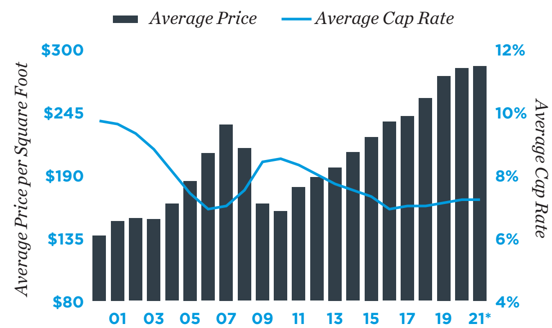
2.7% decrease Y-O-Y

- During 2021, the rise in vacancy coupled with sublease space being offered at a discount will suppress rent. The nationwide average asking rent declines to $27.81 per square foot, down 2.7 percent annually and 4 percent from the all-time high achieved in the opening quarter of 2020.

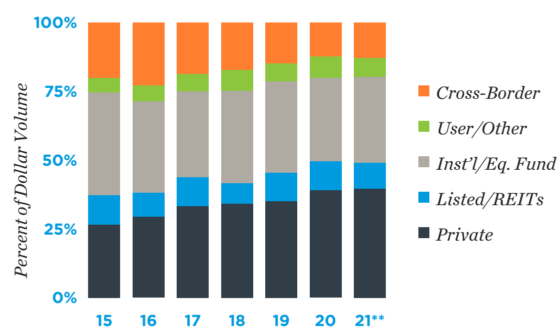
2021 INVESTMENT OUTLOOK

- **Office market remains bifurcated.** The total number of transactions for properties $1 million and above declined 20 percent during the past 12 months ending in March, while dollar volume retreated 40 percent. Top-tier properties and locations remain in high demand with some assets receiving pre-pandemic offers, while pricing for less desirable buildings and settings is still in the discovery process. Operators of quality assets in good locations may want to improve tenant rosters to receive multiple offers.
- **Flight to safety motivates investors.** Increased trading activity for Class A assets drove prices higher. Over the past four quarters, the average price of all office transactions nationwide rose 2.5 percent to $285 per square foot. The average cap rate, meanwhile, held steady at 7.2 percent, remaining in the low-7 percent range since 2017. Investors will scrutinize weighted average lease terms (WALT); this is having a major impact on liquidity and value.
- **Additional investors move back into the market.** After a brief pause, well-capitalized investors, including those from outside the U.S., are returning to the market. Transactions for assets $20 million and above have surged more than threefold since the trough in the second quarter of 2020. Premier buildings in the nation's largest office markets continue to garner investor attention. These assets can trade at nearly $800 per square foot. Premium properties in less densely populated areas are also drawing buyers to markets including Charleston, South Carolina, Richmond, Virginia, and Ventura County, California.

Sales Trends



Buyer Composition Trends



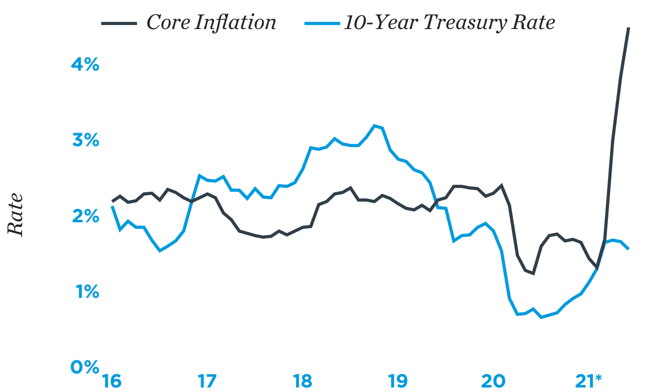
* Through 1Q; ** Trailing 12 months through 1Q
Buyer composition for sales $2.5 million and greater
Sources: CoStar Group, Inc.; Real Capital Analytics

Capital Market Operations Largely Resume; Inflation Concerns Becoming More Apparent

Fed positions for temporary higher-inflation period. Applying lessons learned from the global financial crisis, Congress and the Federal Reserve acted swiftly to preserve market liquidity and support borrowers amid the pandemic last year. As U.S. infections recede and the economy reopens, attention is shifting to the potential longer-term ramifications of these actions. The rapid increase in money supply from multiple stimulus provisions paired with low interest rates and disrupted supply chains has led to higher inflation, with core CPI climbing 4.5 percent annually in June. While above earlier expectations, the Federal Open Market Committee (FOMC) still considers this a transitory concern and intends to allow inflation to stay above the traditional 2 percent growth target for longer than it has in the past. The Fed also expects to keep the overnight lending rate low for the near future, citing still-high unemployment as one reason to hold off. More committee members are now open to the prospect of raising rates in 2023, however. Current quantitative easing practices will also remain in effect for the time being. The FOMC will wait for more substantial economic progress before tapering asset purchases, although some pandemic period programs have already expired.

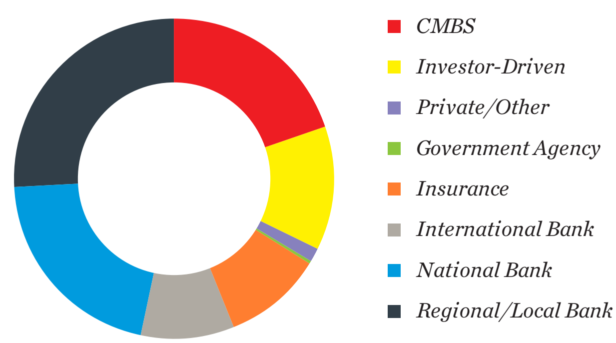
Lenders, like the economy, are opening back up, with financing available for quality properties. Following significant disruptions last year, the majority of lenders are now active and anticipating larger volume after 2020's slowdown. Sentiment is improving, aided by greater population mobility that will help properties in commercial and travel hubs that were disproportionately affected by lockdowns. Lenders are nevertheless favoring borrowers with whom they have an established and positive relationship. A borrower's credit worthiness and track record bear considerable weight when accessing capital, as does recent property performance, including rent collections. More opportunities are available for assets that demonstrated durability during the pandemic or are now in a strong recovery position. Banks and credit unions are offering competitive lending rates at generally pre-pandemic levels of leverage for a range of high-quality properties. Life insurance companies are modestly more selective by comparison, while CMBS securitizations are now underway. For more challenged assets, bridge financing may be available from debt funds and other sources, at correspondingly higher lending rates. Overall, while lending volume is not anticipated to recover to 2019 levels, the impact of the health crisis on capital availability is expected to be less severe than that of the global financial crisis. The external nature of the health problem and critical efforts taken by Congress and the Federal Reserve have maintained and are improving liquidity in the market.

Inflation and Interest Rate Trends



* Through June
Sources: BLS; Federal Reserve; Real Capital Analytics

2020 Office Lender Composition



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Sources: IPA Research Services; Bureau of Labor Statistics; CoStar Group, Inc.; eMarketer; Federal Reserve; Real Capital Analytics; The Conference Board; U.S. Census Bureau