Stranded Assets?

Photo Credit: Bigstock Photo: Grand Warszawski

Are office buildings largely redundant now: temples to a dying dynasty rendered obsolete by technology? If so, where does that leave Central Business Districts (CBDs), their raison d'etre diminished or departed? Since the end of the pandemic the furor about office use has raged in the media with arguments for and against working from home taking center stage. Time, we think, to separate fact from rhetoric.

Significant emotional events such as wars, floods, hurricanes, pandemics, financial crises and major recessions are frequently catalysts for change, especially if they coincide with technological advances. Indeed, they reinforce each other: crises force businesses to reevaluate their operations, often encouraging the adoption of emerging technologies that promise greater efficiencies or reduced risk of impact from external events. We have been here before: past experience may be our guide.

The only real estate market meltdown in the recent history of Atlantic Canada was triggered by the recession which washed up on our shores in May 1990. It is the last significant downturn we have experienced (the world financial crisis of 2008-2009 did not have the same impact). The recession was caused by inflation (5%) and the Bank of Canada's monetary policy as it attempted to curtail it. It caused businesses to re-evaluate their modus operandi and promoted the widespread adoption of the Internet (actually invented in 1983) and mobile phones (launched in Japan a decade earlier). It is difficult now to envisage life without either of them: they facilitate mobility and untether us from a fixed office location. The financial stress created by the recession also called into question the desirability and necessity for elaborate offices located in Central Business Districts; impecunious clients and shareholders were likely to look askance at the proliferate workstyle of their employees. Thrift and egalitarianism bested opulence and elegance. Firms responded; the great unwashed were consigned to less salubrious quarters, back-office operations migrated out of downtown areas to the bowels of industrial parks where accommodation was cheap and distractions less enticing. The banks, in a fit of remorse, sold their towers. Gloom settled over the land. Is it possible therefore to trace the seeds of office decline back to those awful days, thirty-three years ago? The impact of the recession on office property values was brutal. Buildings in Halifax CBD lost 55% of their value as panicking landlords, chasing a diminishing pool of tenants, slashed Base Rents to zero to capture occupants capable of paying the Service Rent i.e. the building's operating costs. Smaller markets in the Atlantic Region were less impacted, presumably because there was more co-operation between landlords. By 1998 the office market, still dazed and dejected, licked its wounds, and stirred back to life as tenants started to return. Base Rents started to creep up again but have never exceeded their pre-recession nominal value in the Central Business Districts. Offices in Business Park locations however, were able to secure higher Base Rental increases and narrow the rental gap with the downtown. In part this was due to the migration of back-office operations from CBDs to the Parks but also because web sites had lessened the importance of "prestige" locations and accommodation. Greater mobility, facilitated by cell phones, favoured locations in the Parks with their easier access and free parking.

New office supply since the 1990 recession has been driven primarily by low interest rates, the lack of other investment opportunities in the Stock Market, and the emergence of Real Estate Investment Trusts (REITs) as purchasers for the finished product, rather than demand from occupiers. Although some cities started to expand supply again in the mid-1990s most construction took place from 2000 onwards. Moncton was the first to bounce back, followed by Saint John, Fredericton, Charlottetown, Halifax and St. John's in that order. Construction was anemic everywhere apart from Moncton and Halifax and sometimes only occurred because of government participation. However, a rising tide lifts all boats and the office sector has benefited from increased interest in commercial real estate as an investment vehicle. Competition for commercial real estate of all types has driven down the rates of return investors are willing to accept, thus reducing capitalization rates and increasing property values (from 2007 to 2016 the increase in property values was also partly the result of rental rates recovering from their abysmal 1990 recession level).

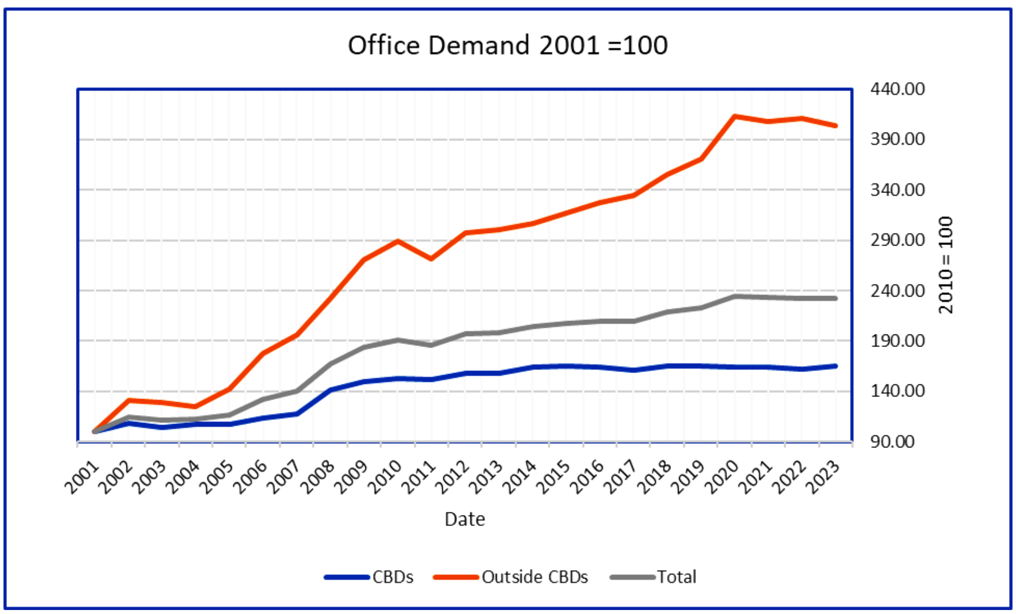
Covid-19 aka WFH

The first case of the virus reached Canada on January 25th 2020 and Covid-19 was officially declared a pandemic by the World Health Organisation on March 11th. The first confirmed case in Atlantic Canada was on March 11th., a woman who had travelled to France returned home with it to New Brunswick. Cases were confirmed shortly thereafter in Prince Edward Island and Nova Scotia. Newfoundland had its first case on March 14th. On March 17th most bars, dine-in restaurants, theatres, and indoor play areas were closed. Shortly thereafter Atlantic Canada, mindful of its limited health and financial resources, shut itself off from the rest of the world. Although the provinces did not mandate working from home (WFH) it was actively encouraged and for all intents and purposes became the de-facto modus operandi for most offices in the Region. Like many service industry firms, we were already using video conferencing and collaborative software, but prior to the pandemic it was a hard sell, people still preferred face to face interaction. However, during the pandemic, Zoom, Microsoft Teams, GoToMeeting and other collaborative software became ubiquitous.

Most businesses started to return to some variation of in-person working in March 2022, on the second anniversary of the pandemic. The pandemic coincided with and was partly the cause of a labour shortage. After the pandemic ended, business elsewhere in Canada started to hire staff in the Atlantic Region to work from their homes. Employees used to working from home were reluctant to relinquish the convenience of popping bedsheets into the dryer between spreadsheets. Employers, mindful of the labour shortage were loath to push the issue. Thus began the great debate, the outcome of which may decide office buildings' fate.

There is a lot to be said for working from home from an employee's perspective. The time savings and flexibility may be conducive to a happier lifestyle. Even in Atlantic Canada the elimination of commuting time can save an hour or more a workday. Child care including school pickups, extracurricular activity, doctor's appointments and the other myriad calls on parents' time can be more easily accommodated if one or both adults work from home. The flexibility too is enticing, planning one's workday around recreational or exercise activity instead of shunting them off to the evening. There is also a case to be made that tasks requiring uninterrupted, concentrated activity can be accomplished more productively away from the interruptions and other distractions of an office environment. Gender equality too is advanced: if both partners work from home, each can pitch in with the cooking and housework. And studies early in the pandemic appeared to support the case for working from home, citing productivity gains of up to 13% for knowledge-based workers happily communicating and coordinating with co-workers via Zoom, Teams, Webex, GoToMeeting and Slack. Lately however some of the downsides have started to surface and information technology firms such as Amazon, Apple, Disney, Google, IBM, Meta… and probably Twitter, now that Elon Musk has assumed control, are mandating a return to office working for three days per week. In May, Canada's largest bank, RBC, mandated a minimum "three day on-site working" citing productivity concerns if their staff continued to work from home. Financial giants BlackRock, JPMorgan, Goldman Sachs now require their employees to work from the office four or five days a week, as does Disney. JPMorgan has abandoned hybrid working (from home and office), CEO Jamie Dimon telling clients that remote working "slows down honesty and decision making". He has mandated a trend-setting five-day office week. Some earlier studies, much relied upon, such as Harvard University's Natalia Emanuel and Emma Harrington "on-line retailer" study which found an 8% increase in productivity when employees worked from home, have now been revised to a negative 4% as more data has become available. A more recent study by researchers at Stanford University suggested that working remotely lowers productivity by around 10% and sometimes by as much as 20%. A separate study of in-home call centre workers in India, by the non-profit National Bureau of Economic Research, found an 18% reduction in productivity. While there are benefits to the employer in terms of savings in office and other on-site servicing costs, these can be out-weighed by the additional costs of supporting personnel working from home. During labour negotiations earlier this year, working from home was one of the desired outcomes for the civil servants involved. The Federal Government objected, citing the additional management costs this would entail. That was our experience as well during the pandemic. Our thirty or so staff were only able to work from home because of the herculean efforts of two office bound staff willing to put in ten-hour days. Communication and employee interaction can also prove to be an issue: video conferencing such as Zoom is a much more sterile environment than a personal face to face meeting and does not generate the same spontaneous exchange of ideas. People complain that collaboration tools such as Teams only work if others answer their questions in a timely manner. The "onboarding" experience is much more difficult and stressful for a new employee, however skilled, when they have to rely on Teams or similar communication tools … the subtleties, idiosyncrasies, corporate culture and personal sensibilities of co-workers can be best understood and more effectively managed via human interaction. Humans are social animals. The problems are compounded when a new employee has to be trained …much knowledge is imparted through chance conversation, eavesdropping on, or observing, a more experienced colleague deal with a situation or challenge. The commonly cited downsides of working from home are longer hours, more (virtual) meetings, lack of access to equipment, blurred lines between work and family life (the latter manifesting itself in the inability to put work aside when the work day is done… or the feeling of guilt when outstanding work remains in view or in close proximity). Loneliness, the inability to bounce ideas off colleagues, lack of support and concern about being overlooked for promotion are also issues. In our Fall/Winter 2020 Newsletter (Vol. 2 No.120), mid-pandemic but hopeful of a successful vaccine, we rushed in where angels fear to tread, to pontificate on "The Future of Office Buildings in a Post Covid World". We proffered the opinion that the decision whether a firm would adopt a 100%, partial, or 0%, remote working model post pandemic would depend on the character of the company and the functions its employees perform. Almost three years later, with more data available, it is time to take stock.

Office Demand



Source: Turner Drake & Partners Ltd. Atlantic Canada Semi-Annual Survey.

As alluded to earlier in this article, the necessity for offices, especially those in Central Business Districts, was called into question by the 1990 recession. Back office operations migrated to industrial parks, fancy web sites substituted for prestige offices in CBDs, and the widespread use and development of cell phones rendered everybody more mobile. This trend was further boosted by the adoption of email for public use in the mid-1990s (it was actually first used internally by the Massachusetts Institute of Technology in 1965); by the 2000s it was ubiquitous. So, what impact did the foregoing have on office demand? Our Economic Intelligence Unit conducts semi-annual office surveys in the six major cities in Atlantic Canada (Halifax Regional Municipality, St. John's, Charlottetown, Moncton, Saint John, Fredericton) on every building available for rent with a gross leasable area of 5,000 ft.2 or more. It is the most comprehensive survey ever conducted in the Region and currently covers 25 million square feet of office space. The graph above details office demand since 2001 indexed to that year. Unfortunately, no demand figures are available prior to that date. However, we had reviewed new office construction in all five cities between the recession in 1990 and 2001 to build up a picture of demand during that period. We bore in mind that two cities, Halifax and St. John's, already had a surplus of office space at the start of the recession and construction of new space, started before the recession, continued to come on stream during and immediately after it. Total office space demand fell during and immediately after the recession and then recovered very slowly during the next ten years. The graph then shows it increasing only slowly until 2005. So the 1990 recession, and more importantly its stimulus in the adoption of new technologies (Internet, cell phones and email) retarded total office space demand growth for 15 years. Areas outside the Central Business Districts were the beneficiaries of changes in workstyle engendered by the recession. Even so office demand growth only took off in 2004, fourteen years after the start of the recession. CBD office demand enjoyed a growth spurt in 2007 but it was short lived: demand growth since 2008 has been anemic.

The Covid-19 pandemic also halted office demand growth: it stalled at the beginning of 2020 and has not recovered ("demand" is based on the amount of office space leased and does not reflect unoccupied space that may be available on sub-lease… it therefore overstates real demand, since lease terms typically run from 1 year to 5 years in this Region). Efforts to migrate workers from their home to an office environment, which started in earnest in March 2022 have had some impact and, as alluded to earlier in this article, the charge is being led by a private sector anxious to improve productivity to pre-pandemic levels. Cell phone activity in downtown Halifax for December to February 2023 was 74% compared to the same period in 2019, higher than all major cities in Canada other than Mississauga, Ontario. However, a Statistics Canada survey (Table 33-10-0658-01) found that only 7% of Atlantic Canadian offices expected to be back to normal 100% on-site staffing during the first quarter of 2023. Another StatCan survey found that Canadians lagged their American counterparts and as of December 2021 were half as likely to return to the office. Clearly there is some way to go before we are back to normal. An appeal by the Halifax Chamber of Commerce for example, to the Halifax Regional Municipality requesting they take a leadership role by mandating their downtown municipal workers be in their offices three to four days a week was summarily dismissed by Mayor Savage and downtown district Councillor Waye Mason. The Federal Government however has mandated its employees back to in-person working two to three times a week: the United States and United Kingdom governments have also implemented in-person work policies. We suspect that in-home working is likely to be more prolonged in the public, rather than the private, sectors of the economy in Atlantic Canada.

Climate Change

Technology, migration of office jobs to industrial parks and working from home are not the only challenges faced by offices in Central Business Districts. Most downtowns in Atlantic Canada are located close to the ocean or rivers, a relic of their founding when travel and conveyance of goods was waterborne. They are thus vulnerable to sea level rise from climate change; water volume increases as waters warm and expand. Melting ice sheets and glaciers also increase water volume. In our Summer 2007 Newsletter we studied the impact on Halifax, NS and Charlottetown, PEI and published the results on our Corporate web site www.turnerdrake.com as the research paper "That Sinking Feeling". Our report of Doctor Who's future visit to the Halifax CBD on April 1st 2063 was documented in our Spring/Summer 2013 Newsletter and repeated as research paper "Back to the Future". Following the U.S. National Oceanic and Atmospheric Administration (NOAA) Technical Report, we updated the information on Halifax, NS and Charlottetown, PEI in our February 2016 and August 2017 Newsletters and also included the Shediac Coastal Areas of New Brunswick and St. John's, Newfoundland. That information was published on our web site in the research paper "Sea Level Rise". In 2019, we met with climatologists ClimAction Services, a Halifax based climate and weather consultancy, and asked them assist us identify the threat to real estate in Atlantic Canada from flooding due to pluvial (rain), fluvial (watercourses) and coastal (or surge)… and its time line. We published the results in our Summer 2019 Newsletter and in a research paper "Wilder, Wetter, Warmer" on our Corporate web. None of these articles garnered us a Pulitzer Prize but our Valuation Division now identify and consider Climate Change Concerns in every assignment and we are decidedly less excited about property in the proximity to or with water frontage. At the time of our research we anticipated global warming of 1.5 degrees Celsius over pre-industrial times by 2050. It now looks as though we will achieve that unhappy state before 2030; the World Meteorological Organization's May 17th 2023 report estimated that there was a 66% chance of reaching it within five years. North Atlantic Ocean temperatures are now at record highs due to global warming (as well as high pressure over the Labrador Sea and the lack of Saharan dust). This increases the risk of hurricanes reaching Atlantic Canadian shores and the resulting storm surges. Global warming places any office (or other) building that is below the 5 metre tidal benchmark (chart datum) at risk of flooding. Reading our articles today, a scant four to sixteen years later, the scenarios they postulated appear understated. Of course, it is not just office buildings in CBDs that are at risk. Many residential buildings are located close to the water as well to take advantage of the views they offer.

Conclusion

Office buildings face some challenging years ahead, particularly if they are located in a Central Business District. The 1990 recession forced a change in workstyle (back-office jobs migrated out of the downtown) and escalated the adoption of new technologies (web sites, cell phones, email) which facilitated mobility, including working remotely. The recent pandemic has had a similar impact. It rendered routine a "work from home" workstyle that was available, pre-pandemic, to a minority of office workers. This in turn forced the widespread adoption of emerging technologies such as video conferencing e.g. Zoom, and collaborative tools e.g. Microsoft Teams and rendered them daily events. It released workers from their offices and tethered them to their cell phones and laptops instead. It also brought the workplace into the home; almost a quarter of Canadians did most of their work from home in May 2021 up from 7.4% in May 2016 according to Statistics Canada. A lot of that increase was due to the pandemic, it remains to be seen how much of that in-home working continues. It is likely that most firms and employees will settle on a more relaxed workstyle that balances lifestyle with productivity and reflects the particular demands of the job, training obligations, and personal interaction with colleagues.

Central Business Districts - the experience of the 1990 recession suggests that it may be fifteen years after the end of the pandemic in March 2022 before office demand starts to grow again. In our opinion this is in the municipality's gift. Major investors such as the REITs and pension plans have already signaled their views: they are bailing out of the CBD office market, selling their holdings to local entrepreneurs. Some of these entrepreneurs are residential developers intent on taking advantage of the housing shortage by converting offices to apartments. CBD office rents used to command a substantial price premium over locations elsewhere, reflecting the "prestige" value of their location. Most of that premium was destroyed by the impact of the 1990 recession and the widespread adoption of the Internet (web sites), cell phones and email. Mobility and free parking in the business parks trumped the prestige of a downtown location. None of that has been much amplified by the Covid-19 pandemic: downtown has already taken its knocks. The risks of contagion implied by crowded lobbies and streets, elevators and similar situations are fading and will not have a lingering impact unless there is another pandemic. People already visit theatres, crowded restaurants, public transport et al confident that vaccination, or luck, arm them against infection. Nor, in our opinion, is working from home quite the threat it is portrayed. There are considerable downsides to both firms and their employees. Many of the information technology giants have already measured the loss in productivity, training, communication, culture and creative thinking and are mandating the return to a more collaborative environment built on personal interaction. Even Zoom has implemented a tentative "two days in office per week" operating model. Additionally, from an employee's viewpoint, work stress may be acerbated by the inability to separate work from home activity. Emails and voice mails via smart phones and laptops already tether employees to their work. Even if employer policy favours ignoring them outside work hours they may be hard to ignore. Unfinished work files are doubly difficult to put out of mind when they lurk at home, even when they are out of sight. The downsides of working from home, especially with children, or for on-boarding new employees will, we suspect, outweigh its advantages in the longer term. Downtowns can be vibrant and exciting places to work if municipalities grasp the opportunities they afford instead of treating them as real estate tax "cash cows" (Halifax and St. John's take note!). The Baby Boomers are retiring, selling their homes and rehousing into worry free rental accommodation. Where better to relocate than a downtown with its restaurants, coffee shops, bars, entertainment, parks and medical facilities within walking distance, if it is crime free and visually attractive? This wave of retirement will continue through to 2030 and its impact on high quality rental accommodation is already evident. Apart from the Baby Boomers there is a high demand for residential accommodation due to the Region's expanding population. Much residential space is already being built in or close to downtowns in the Region's cities. The conversion of redundant or obsolete office space will reinforce that trend and create the opportunity for twenty-four-hour CBDs populated by office workers during the workday and residents all of the time. As the stock of office space is reduced through repurposing or demolition the offices remaining should find a ready rental market provided the municipality is willing to invest in the infrastructure to render downtown an attractive place to live and work. How long will that take? It depends on the municipality, some such as Moncton are already proactive, but in most cases we are probably looking at a ten to fifteen year timespan.

Outside the CBD – office space was a beneficiary of the move out of the CBD triggered by the 1990 recession. There is no similar benefit from the recent pandemic. Instead there is the threat of reduced office demand resulting from people working from home. We believe that this threat is overstated. Much of the increase in this activity noted by the March 2021 Statistics Canada survey was due to the pandemic. Empirical data suggests that a significant portion is due to firms outside the Region employing people within it working from home. These are new jobs created by countrywide staffing shortages and do not detract from office demand. We therefore anticipate that office demand will recover once the lingering impact of the pandemic and the current economic slowdown are over.