March 13, 2013

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Changing Office Trends Hold Major Implications for Future Office Demand

Pioneered by Tech Firms in California, Communal Workspace Model Becoming More Mainstream Among Big Office Firms

Perhaps just as the inevitable disappearance of music, video and books stores should have been foreseen at the onset of a digitized connected world, so too should the commercial real estate industry start taking a hard look at changes occurring in the office market.

Tenants are downsizing their offices, particularly larger public firms, as they increasingly adopt policies for sharing non-dedicated offices and implement technology to support their employees' ability to work anywhere and anytime, according to Norm G. Miller, PhD, a professor at the University of San Diego, Burnham-Moores, Center for Real Estate, in a webinar he presented to CoStar subscribers last week.

Miller said he put together the webinar to examine what would happen if office tenants used 20% less of the nation's current office space, which has a total valuation of $1.25 trillion. That decrease in demand would represent $250 billion in excess office capacity. Although the current situation is not that dire, Miller said the trend is real, and he presented how it is currently playing out and the long-term implications for office building owners and investors.

Following the webinar, CoStar News interviewed Dr. Miller for a more in-depth discussion of the topic and surveyed a wide sample of webinar participants to share their firsthand account of the ongoing trend and its implications.

According to Miller, four major trends are impacting the office market:
* Move to more standardized work space.
* Non-dedicated office space (sharing), along with more on-site amenities.
* Growing acceptance, even encouragement of telecommuting and working in third places, and
* More collaborative work spaces and functional project teams.

“Historically, under the old corporate hierarchy, everyone had their own assigned office or work desk and we saw utilization rates of 50% or so,” Miller said. “Firms that have moved to sharing space are seeing much more efficient utilization rates of 80% to 95%, sometimes using conference space seats to handle unexpected overflow. Some also have arrangements with temporary office space vendors like Liquid Space, Regus, HQ, Instant Space, as well as supporting employees working from home or third places.”

“The average amount of leased space (per employee) has been shrinking,” he said. “As of mid-2012 the average was 185 square feet per worker, well below the average space assumption in most office-demand models, and well below figures 10 years ago.”

There have definitely been changes in office demand, agreed Tim Wang, director and head of investment research for investor Clarion Partners in New York.

“Ten years ago, 250 square feet per office employee was the gold standard in office real estate. Today, that average has dropped to approximately 195 square feet. While some office tenants are hesitating to commit to large leases primarily due to economic uncertainties, the long-term trend is clearly shifting towards efficient space usage."

Brian J. Parthum, who tracks employment and economic trends for Southeast Michigan Council of Governments (SEMCOG) in Detroit, said his group is a case in point.

"Our own organization recently moved into a smaller space," Parthum said. "Efficient office design has allowed us to rent 7,000 square feet less space -- down from 34,000 square feet -- and at a lower rate. Additionally, we now have an office that is more attractive to the next generation of staff. The new space takes advantage of natural light, promotes face-to-face contact, and utilizes laptops, wireless technology, and mobile devices to allow for a more flexible work environment."

"Technology is allowing companies to be more paperless and work from a single laptop or device," agreed Jason Lewis, president and managing broker of EcoSpace Inc. a brokerage firm in Denver that specializes in working with tenants to find sustainable workplaces. "Culturally the new generation of employees is requiring a more flexible and open environment. And in regards to the economics, there is the need for both startups and corporations to lower their burn rate and conserve cash, something that can easily be done by restructuring the way they view their office space," Lewis said.

For now, at least, the trend is more prevalent among large corporate office users with locations in multiple cities. John G. Osborne, executive director, leasing and marketing at Bergman Real Estate Group in Iselin, NJ, said also that the trend to shared office space is more prevalent among larger publically traded companies than smaller firms.

"The majority of our smaller tenants, those that lease less than 5,000 square feet, still prefer private offices than an open plan," Osborne said. "The majority of our smaller tenants, those that lease less than 5,000 square feet, still prefer private offices than an open plan," noted John G. Osborne, executive director, leasing and marketing at Bergman Real Estate Group in Iselin, N.J.

For many office-using firms, the Great Recession made downsizing a greater imperative. Occupancy rates dropped across the country as employers downsized staff and sought efficiencies through lower square foot per employee footprints.

"Everything we've seen since 2006 and 2008 could be called the 'Great Deleveraging,'" said Wilson Greenlaw, vice president of Thalhimer in Fredericksburg, VA. "Companies were removing fluff and eventually someone got around to looking at space utilization. Now that it is on the table, it will be maximized and implemented, resulting in a cultural shift for the office worker."

"Some of it is economic," agreed Miller. "That is, companies realized they could save money by minimizing excess space. But I believe the single biggest factor driving this trend is technology. Now that we have moved to cloud-based file storage and can access our work from anywhere and it can be easily shared, workers no longer have to be tethered to an office to be productive. Technology is very much at the heart of this transformation."

Collaboration, Not Telecommuting, Is the Goal

Stephen Siena, senior research analyst for Jones Lang LaSalle Americas Inc. in Tampa, said there is also a change in business culture going on as well: the desire for more collaboration.

"In my view, cost cutting is likely to go away as the good times return," Siena said, "but the open floor plate will become the norm because of the heightened productivity and creativity it provides. For this reason, I also think the technological aspects (telecommuting) will not be nearly as dominate a force as many expect. Open floor plates and more common space seem to be the antithesis of telecommuting."

The addition of more on-site amenity space for office employees has helped to somewhat offset the reduced demand for space from telecommuting for landlords and reflects a reaction to some of the extremely long hours that these employees often work, said Garrick Brown, director of research at Cassidy Turley in San Francisco.

“The interesting thing that I have found about telecommuting is that it does not work in economic downturns or in the kind of atmosphere of fear that you see with struggling companies,” Brown said. “Look at Yahoo’s recent announcement that they were cutting back significantly on allowing employees to telecommute. Whenever companies are in trouble, telecommuting goes out the window. This is driven mostly by management, who in times of struggle often revert to old-world thinking about how to measure worker productivity and become clock watchers instead of looking for results in terms of end product.”

“But it is also driven by worker paranoia. If your company is downsizing, suddenly you want to be highly visible in your workplace, regardless of whether you may actually be just as, if not more productive, working from your home office,” Brown said.

Essentially what we are seeing is the adoption of the communal workspace model that a lot of tech companies have pioneered over the last couple of years by non-tech users, said Brown.

“There have been a few tech firms in the San Francisco Bay Area that have gotten to worker densities of up to seven workers per 1,000 square feet of space,” Brown said. “The average back around [the year] 2000 was four workers per 1,000 square feet. Heading into the downturn in 2008 it stood at five per 1,000 square feet.”

“Though the tech companies do use more space for communal recreation and other amenities (such as game or recreation rooms, massage and stress-reduction rooms, nap rooms, etc.), they have abandoned the cubicle and the corner office and many have freeform sitting arrangements,” he said. “Everyone has wireless connections for their laptops, tablets and smartphones and people roam around. They have communal meeting rooms that can be used for meetings or private calls and projects.”

More People Means More Stress On Facilites

Squeezing more people into existing or even smaller spaces is putting structural stress on an office buildings systems, such as parking, elevators, restrooms and utilities that were not designed for the new demands of density that occupiers are seeking, noted Christian Beaudoin, director of Jones Lang LaSalle in Chicago.

This unforeseen consequence of higher density is often overlooked, agreed Miller.

“The tenant saves a little money by leasing less space, but the biggest property impact is on parking demand. It can increase by 50% or so. Some buildings need seven spots per 1,000 square feet for the intensively used space,” Miller said.

Kim Kelley Richards, senior project manager for Gola Corporate Real Estate in Norristown, PA, said it is becoming increasingly more difficult to accommodate parking. "Having more tenants in space that was initially planned for 4 (parking space) per 1,000 square feet puts additional stress on building mechanical systems, and impacts fit-out costs due to the need for additional electric, heating and cooling. In some cases we are even seeing bathroom facilities and janitorial services impacted.”

“In addition to downsizing their space, tenants are increasingly downsizing the ‘deal,’” said Thalhimer’s Wilson Greenlaw. “Tenants are nervous. Long leases used to be 10 years. Then they were seven and five years. Now they’re three years around here. The compensation to brokers is greatly reduced for the same amount of work.”

Shaking Up Office Fundamentals

What the downsizing trend means for office fundamentals in the long term remains mostly conjecture at this point, but it is widely perceived as holding major implications for those who invest in and underwrite office space.

The dollars and cents of it are fairly obvious, said Ron Berkebile, management and budget analyst for the City of Virginia Beach, VA

“For businesses, there is a rent expenditure offset. While green buildings command a higher per-square-foot rate, businesses require less square footage.”

Hypothetically, Berkebile figures it like this. A 20,000-square-foot space in a standard office building that rents for $18/square foot has a total annual cost of $360,000. A more efficient layout in a newer, green building in which the same tenant may occupy only 15,000 square feet but may have a rent of $20/square foot for a total annual bill of $300,000.

“The tenant benefits with green building workspace; employees are happier; and rent reductions are achieved. Alternatively, the building owner benefits from premium rates and more tenants,” Berkebile said.

Ultimately, Miller and other experts believe, the trend toward more-efficient utilization of office space will continue to have an impact.

"I see office demand at the user level falling by about 20% over the next decade,” said Cassidy Turley’s Garrick Brown. “This is actually a more conservative number than I have seen from a lot of other analysts, but I think the aforementioned trend of old world thinking interfering with telecommuting will never go away completely.”

“Also, while I see a lot of businesses adapting the tech model and squeezing the most out of their square footage usage, I think there are some fields where this just can’t happen for pure logistics sake. Call centers, for example, where cubicles serve a real purpose and allow for call center employees to reduce noise. You don’t have that in these new open space designs,” Brown said.

Importantly, Brown sees a distinction between the long-term trend towards companies using less office space per worker, and overall demand for office space as measured in office absorption, which he expects will tick-up over the next couple of years as companies return to growth mode in a recovering economy .

“We will see declining vacancy and increased occupancy growth in the short-term… but the footprints of users will be less and the long-term trend for office demand will be impacted,” Brown said. “This trend may not really show up in the stats for quite some time as it will be masked by the general uptick in office demand.”

In addition, most of the downsizing is coming from decreased square footage for “work space” in a building and not in the amount of public and shared space, which actually is increasing, according to Norm Miller.

“Based on anecdotal evidence, I’d say for every two square feet a firm gives up in individual office space they add one square foot of extra and flexible meeting space,” Miller said. “This mitigates the downsizing somewhat, and instead of going from say 250 square feet to 125 square feet they end up at 150 or 175 square feet, and firms targeting to go down to 100 square feet will probably end up at 125 to 130 square feet based on my simulation research,” Miller said.

The shift will also affect geographies and individual markets differently, Miller said.

“The places where space becomes excess and where tenants are growing never seem to match up," explained Miller. "We will always see new construction in any market with any economic growth. Markets like Detroit might decline but not because of workspace trends, just because of city-based issues,” Miller said. “In some markets like Washington, DC, with so much government space, I can see significant impacts and less need for net new space. But then again, much of that space is obsolete and it is hard to retrofit some older buildings, so it will most likely mean a slowdown in new space with a significant portion of newly retrofit and reconfigured space.”

“But again, the obsolescence of much of the existing space will mean we will see new space built, albeit at a slower pace than before. Also markets like Boston, Chicago, New York, San Francisco, LA and even Cincinnati will be affected with a slower rate of new construction and more rapid pace of retrofits," he said.

Jones Lang LaSalle's Beaudoin said those same factors -- the constraints of the existing inventory and the downsizing trend -- also result in more build-to-suit activity, despite historic high levels of vacancy.

"Downsizing trends will not negate the need for new space, because much of the existing stock is not suited for the workplace of the future," observed Beaudoin. "There will be huge opportunities for clever developers and architects to repurpose obsolete offices throughout the U.S."

Another consequence is the opportunity to convert former office buildings to other uses.

The trend "is helping us (to convert) some of the less-desirable office space to residential units to take advantage of downtown's increased attractiveness to young professionals and the businesses that are seeking to recruit them," noted Vince Adamus, vice president, real estate and business development for the Greater Cleveland Partnership in Cleveland. "From what was assumed to be a negative situation, a more efficient and more attractive environment is shaping up."

To be competitive in the future, office space needs to offer natural light, better temperature controls, better ventilation and options for more flexible reconfiguration, he said.

Miller identified three major implications for landlords.

* Nearly all of the existing office space could be reconfigured more efficiently with better natural light, more energy efficiency, healthier better ventilation and more sound control.
* Great designs will try and minimize interruptions and provide flexible work space. And
* Landlords are not selling space but productivity and more productive space will command higher rents per square foot.

Just a Fad That Fade When Good Times Return?
For the landlord hoping the downsizing is just an over-reaction to years of recessions and slow growth, Jason Lewis, president and managing broker of EcoSpace in Denver, says: "Not a chance!"

"Downsizing is here to stay as the new generation of workers will keep requiring a more collaborative, flexible and social work environment. With increased density of populations and increased ability to work mobile, the need for huge corner offices and closed wall work environments will be all but extinct in the near future," he said.

Says Paula Buffa, senior director of Cushman & Wakefield of Florida in Tampa, "I do think some companies will add employees back to their roster but not to the level as before. Companies have learned to make do during the past couple of years and I believe most will maintain with status quo or, if they add employees, not to the level of the past."

Norm Miller agrees. "It is just like sustainability. It makes economic sense and puts pressure on firms to think harder about securing productive space, independent of size. This downsizing will parallel the move to more sustainable space, with more natural light and ventilation and more flexibility, with some privacy options and a these trends are irreversible as our use of digital files instead of hard copy files. But it takes time and it always takes longer than I expect."