Episode 16

Are we there yet?

Return to office and its impact on commercial real estate investors.

Kara O'Halloran (00:05):

Welcome back to FireSide, a podcast from FS Investments. My name is Kara O'Halloran. I'm a Director on our Investment Research team. And while I think we always have really interesting topics, I think today's conversation may be one of the most timely and relevant that we've had yet, and that is return to work. This has been the question over the last year and a half; bringing employees back to the office in a safe way has certainly been top of mind for many companies. It seemed like things were trending towards a return in September, but the delta variant had other plans for many companies. We talk about where the office sector is now, where it's headed and what that may mean for investors.

Kara O'Halloran (00:40):

I could not have two more appropriate people to talk about this with. I am so excited to bring you this conversation between FS's own Steve Oblack, who is an Executive Director on our Client Portfolio Management team, who specializes in commercial real estate, and Phil Orban, who is a Managing Director at Rialto Capital Management. Rialto is an integrated real estate investment and asset management company that invests and manages assets throughout the capital structure in real estate properties, loans and securities. I hope you enjoy the conversation.

Kara O'Halloran (01:11):

Steve and Phil, thanks so much for joining. I will let you guys take it away.

Phil Orban (01:15):

Great. Thanks, Kara.

Steve Oblack (01:15):

Thanks for having us.

Steve Oblack (01:17):

Yeah. Well, Phil, normally I would say nice to see you, maybe if we were doing this a couple years ago. But today, we're not recording in the same room, which is perhaps apropos for our discussion. I believe you're in your corporate office, while I'm still in my home office.

Steve Oblack (01:33):

While I definitely want to get to the outlook and the future of office, I thought maybe you could start for us by taking stock of what has taken place since the start of the pandemic. For me, when I'm talking with commercial real estate investors, from a pricing standpoint, things have remained fairly resilient through the COVID-19 pandemic. Maybe you could talk specifically about what's gone on in the office sector over the last year and a half.

Phil Orban (02:03):

Yeah. Happy to, Steve. Great to connect. The good news is, we are going to see each other in person finally after what, two years or almost two years, so excited for that.

Phil Orban (02:13):

But it certainly goes without saying that office utilization has declined tremendously following the onset of COVID. While I am sitting in my office today, and at Rialto, we have been back in the office for quite some time now, that certainly varies greatly by industry and by market.Phil Orban (02:32):

Anecdotally, I will say coming into the city this morning on the subway, it certainly felt like old times. I think a lot of that's driven by schools finally reopening, which is very exciting for New York City. The subway was crowded, the city, Midtown finally feels alive, but it's been a long time getting back to that.

Phil Orban (02:51):

Looking at office, and I mentioned utilization, there are interesting data points to track. One particular one that we have been focused on is Castle Scanner data, which is one of the largest office scanner security companies in the country. They track 2600 buildings in 138 cities. The top 10 major markets actually only average about 30% utilization as recently as last week. Now office in general, from a credit perspective and from a performance perspective, has performed quite well, and it's simply because office are typically leased on a long-term basis. Tenants, for the most part, have continued to pay rent. A lot of that is driven by the fact that I think most companies do believe they will return to the office and they do need physical office space, in the long-term. As tenants pay rent, landlords have continued to pay debt service.

Phil Orban (03:45):

We actually have seen performance in the office sector be quite steady. We can get into it a little bit further. But Rialto as a firm, we have continued to invest in office, we still see opportunities in the commercial office sector. But as I said, office, certainly how it's utilized has changed in the short term dramatically, in the long-term we have certain views on how we think companies will return and when they'll return. We're getting some more clarity from some larger employers on their return to office plans, although the Delta variant has certainly changed that temporarily. But, happy to talk about this further.

Steve Oblack (04:20):

Yeah. I think that leads in another thing I wanted to talk about. Anecdotally, I remember having a conversation with my wife, back in probably May, June 2020, and I thought I'd be back in the office by Labor Day of 2020. So Labor Day was that unofficial back to office date and like you just referenced, the Delta variant certainly changed it.

Steve Oblack (04:48):

How are you thinking about the current state of the office and return to work?

Phil Orban (04:54):

It's certainly a difficult question to answer generically. Like I said, I think it varies greatly and by market. Labor Day 2021, I think everyone agreed was the unofficial back to office date. Like you, I thought Labor Day 2020 was the return back. I have been back in the office since Labor Day 2020. I think certainly our company was one of the earlier ones to return and we were not fully back, and we're still not fully back today, so get to full utilization will take time.

Phil Orban (05:23):

When you look at it from a market perspective, certain markets, as I'm looking at the top 10 MSAs in the country and some of the larger markets tracked by some of the larger real estate data firms. Texas is certainly leading the way, and if you look at their utilization compared to where they're leased, Dallas, Houston and Austin, they're approaching 50% utilization so they're certainly leading the country in the return to office push. Whereas markets such as San Francisco and New York, two of the larger office markets in the country, are still hovering at or below 20%.

Phil Orban (06:00):

And again, I'm sitting here in New York, as I mentioned anecdotally, on the way in today, the subway's were very crowded. It felt good, it felt alive again. Midtown, the restaurants are opened, I think Broadway unofficially opened this week, so we are seeing things come back. I am believer, from a personal perspective, that New York City is going to return to normal in I call it the mid-term. But again, that's also going to vary by industry. Rialto is a real estate company and I think it's not a surprise that real estate companies were probably the early movers to return to office. Obviously, real estate is our lifeblood and if we're not showing up at the office, how can you expect your tenants and your borrowers to perform as well?

Phil Orban (06:47):

We have been back, and certainly come back in what we view in a safe way. We are seeing other sectors return as well. Certainly the finance sector in general was an early return. Then, there's the technology side and technology tenants have been slow to return. They were early adopters of remote work and they found that remote work does in fact work. But that being said, we've seen large technology firms, while they have not returned to the office, have executed very large leases in major markets. They too expect to return to the office, at some point.

Phil Orban (07:15):

But with the Delta variant, we did see some large employers announce pushbacks on their original return to office date of September 2021. That includes large firms like BlackRock, CNN, American Express, Coca-Cola, among others. They pushed it one month, to October, so that'll be in a few weeks. Whereas large technology firms such as Amazon, Facebook, Google and Apple have already pushed their return to work date to January 2022. When you think about that, that's almost two years of remote work, which is really incredible and it's unprecedented.

Phil Orban (07:52):

But that being said, and I speak to the fact that in the long-term we do believe these firms will return to the office or have a need for physical office space, there are indicators that demand, as tracked by just office visits and tenants looking at vacant space available for lease, is picking up. In certain markets, certain indicators such as Los Angeles for instance, has actually seen an uptick in demand as compared to office visits in 2019. We're also seeing cities like New York for instance, which 2019 had already seen a softening in the commercial office sector in New York City in general, according to one data point that we track by the View Space Office Demand Index, New York demand as tracked by just office tours is back to about 92% of what it was in 2019.

Phil Orban (08:43):

Now again, office tours are not signed leases but it is an early indicator of companies looking for space. Obviously, how companies will use office space on a go forward basis is up for debate. We have seen that larger blocks of space are being toured, and that could be an indicator of companies expecting to need more square footage per employee. But, there's also a theory that you will see more demand for flex space. Anecdotally, I do have friends that live in New York City, I live in Brooklyn, their firms are in Midtown, they have remote work as an option but they don't have the ability to work in their home because New York City, we live in small apartments. I do have friends that have been signing for flex space desks at WeWork or a

WeWork type equivalent that's closer to home. Some do believe that you'll see more demand for that flexible shared workspace on a go forward basis.

Steve Oblack (09:40):

Yeah. That's what's pretty interesting to me. You mentioned there's the return to work aspect, and there's the future of full utilization. What does full utilization look like? Maybe if you have any additional thoughts. How do you think about hoteling or spreading people out? Is it too early to make a projection with what the future of work looks like?

Phil Orban (10:10):

I think it's too early to definitively say what long-term, the future of office work will look like. I do believe there will be more demand for private office space. I think, generally speaking, across the office sector there was a push pre-pandemic to more creative office build out, more interaction, less walls, more open space and encouraging a collaborative work. I think some have called it a trading floor setup. That, just by definition, people are closer to each other, there is less personal space. Certainly, I think in the near term that we might see a move away from that, maybe more spreading out. Again, more square footage per employee, maybe moving back towards more privacy as opposed to less privacy. But, it remains to be seen if there are adopters.

Phil Orban (11:03):

I was speaking with a technology firm yesterday who finished their build out of their office space in lower Manhattan during the pandemic. They stuck to the course and built out a trading floor setup with more of the creative office, young, Millennial driven build out. They are partially back to the office, they expect to be fully back and that's a major technology firm, they've got over 200 employees onsite. There are firms that still feel they're going to stick with their plans pre-pandemic, and have spoken with others who are building out all offices, where everyone has their private space and they can feel more comfortable. I don't know where we shake out, certainly we've seen both. Whereas certain sectors may have less demand and may adopt more work from home, other sectors continue to thrive in the office space.

Phil Orban (11:47):

One aspect of the commercial office that we haven't talked about more is life sciences. We've seen the life science sector, obviously it has major tailwinds coming out of COVID and it was growing strong fundamentals pre-COVID, and we've seen tremendous demand for life science space, throughout the country.

Steve Oblack (12:06):

I think when you bring up life sciences and some of the dispersion that you see inside of the office sector, how is that impacting your firm's thoughts when it comes to making investments in today's market?

Phil Orban (12:22):

Certainly, when we evaluate any investment, whether it be a senior loan or an equity investment, first and foremost we're underwriting the real estate and can we create value in that investment. A lot of creating value is the ability to drive rents, to drive occupancy. Are you buying the asset right, are you buying it below replacement cost?

Phil Orban (12:42):

With respect to life science and how that's impacted our investment approach, we've certainly been evaluating and continuing to see investment in the life science space, but it has to meet our investment parameters. We have looked for assets that we can convert to life science, assets that might be under-utilized or needed capital improvement, and some leasing expertise or management expertise to stabilize the asset. We've certainly looked to invest in tailwind markets. But at the same time, we have looked at contrarian bets. We have acquired office buildings where we felt we could buy well below replacement cost in markets that have improvement fundamentals and positive employment trends, where we can create value simply by leasing space up at market rents and generating positive returns for our investors.

Steve Oblack (13:31):

That's great. Maybe shifting gears a little bit, people always talk about location when it comes to real estate, real estate investing.

Steve Oblack (13:42):

Over the last year and a half, many people have moved. We did an entire episode of this podcast on how red hot the housing market is, and how many people have relocated. Whether that is just exodus of a city to the suburbs, or even a complete geographic relocation, there are a lot of stories, as you know living where you do, about people leaving the center of San Francisco or New York, and maybe even relocating to places like Austin or Miami.

Steve Oblack (14:13):

Could you talk to us about your view on the trend, from a geographic perspective and then, this is a long winded question, but CBD or central business district, towards secondary and tertiary markets?

Phil Orban (14:27):

Yeah, absolutely. I think the data does indicate that the pandemic simply accelerated what was a longstanding American migration patterns. Anecdotally, the headlines certainly in major cities like New York City and San Francisco, where the moving companies are moving out well more than people are moving into the city. Everyone's running for the suburbs or the low cost states. While there is truth to that, certainly there were a lot of temporary move outs in New York City, it is evident that what happened during the pandemic was consistent with what was happening pre-pandemic. There have been net move outs from high cost cities to more high growth sunbelt markets. Some of the bed fishes of Charlotte, Austin and Dallas have continued to increase.

Phil Orban (15:06):

But, I think the predominant outflows in major markets have been to nearby suburbs and I think it's the biggest increases. For instance to New York metro area, I think it was more upstate, some markets such as Hudson and the Kingston area is a recent article I was reading. So you certainly saw more migration out of the major cities into nearby suburbs. But there has been a long-term trend of high cost to low cost moving, and we've seen that, and it's certainly evident in the transaction buying we've seen across our platform. Whether it be senior loan activity or our equity investments, certainly have been more active in those lower cost states with high employment growth and stronger fundamentals.

Phil Orban (15:51):

I will point out that I think data has indicated that a lot of the migration outflows from high cost cities have been from a more mobile demographic. Younger, typically without children, young professionals. They have the mobility and the potential to move back to the cities, when the pandemic ends. Again, it's all anecdotal at this point, but speaking with the younger professionals here at Rialto, the opportunity to get a great deal on a New York City apartment has come and gone. There was a period of time when people moved back where they can get significant concessions, they were upgrading to much better apartments than they could afford pre-pandemic, but we have seen a lot of that vacancy get leased up. And now, it's a matter of some concessions burning off but things are stabilizing.

Phil Orban (16:38):

But again, that is anecdotal. I think time will tell but I certainly won't bet against major metropolitan areas. But there has been tremendous opportunity, pre-pandemic and certainly post pandemic, in some of these lower cost cities that have seen tremendous job growth, simply because of the lower cost of living and the lower cost of operating the business.

Steve Oblack (16:58):

Well, Phil, those are just great insights and you had a lot of great data for us. On an anecdotal point, I spent the first eight years of my professional career living in New York City, there's no place like it. Anecdotally, I will make my first trip back to New York City since the onset of the pandemic. As you mentioned earlier, I look forward to seeing you then. We can clearly talk much longer on this topic, the return to office, but I think we need to leave it here for today.

Steve Oblack (17:20):

Thanks, Phil, and thanks everyone, for joining FireSide and we'll see you next time.

Kara O'Halloran (17:31):

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