OFFICE REMAINS RESILIENT IN UNCERTAIN TIMES

Total returns for office properties decelerated significantly during the second quarter to 0.6% as depreciation of -0.5% offset the 1.1% income return. Looking back over the last year, office properties produced a total return of 5.8% driven by 1.4% of appreciation and an income return of 4.4%. This marks the first quarter of depreciation in over a year for the sector and the third consecutive quarter of being the bottom performing property type across all sectors. The impact of rising interest rates and softening demand within the broader economy are likely to keep a ceiling on the performance of office properties for the foreseeable future. With this in mind, investors have shifted their office allocations to 27.0% within NPI and 23.5% within the NFI-ODCE Index.

Though repricing within the office sector may seem uniform, the situation is much more nuanced at the subtype level. Suburban office posted 9.6% total returns over the trailing year while CBD office only returned 3.0%. The 6.6% return dispersion has reached levels not seen since the GFC. The last time suburban office led CBD office by this wide of a margin was the first quarter of 1998 in the lead up to the dot-com bubble. Suburban’s relative outperformance predated the pandemic and has largely been driven by migration from major cities to the less dense suburbs, a trend that accelerated further after the onset of the pandemic. Conversely, the dispersion of office performance across the four main regions has stayed below the historical average, signaling trends within the office sector remain broadly in line from a regional perspective.

Many major employers within the U.S. have started to walk back their work-from-home accommodations that were the new norm in response to the pandemic, though reactions to this return to normalcy have been mixed. Occupancy within the office sector sits slightly below the historical average at 87.1%, just off the low of 86.9% in the third quarter of 2021. The last time office sector occupancy was below the current level was in the second quarter of 2014 during the post-GFC recovery period. Similarly, year-over-year same store NOI growth has fallen just below the historical average at 1.1% in the second quarter. Contrary to popular belief, NOI growth within the office sector remained healthy throughout the pandemic due to the long-term leases in place prior to the lock downs and overall healthy tenant credit quality. Taking both current occupancy and NOI growth figures into account, it would appear office properties tracked by NPI have been resilient considering recent headline risk.

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